

Lost in Translation:
Rethinking the Politics of Sovereign Credit Rating

A Thesis submitted in fulfilment of the requirements for the
Degree of Masters of Arts in Political Science

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2013

Abstract

Our current understanding of credit rating agencies' influence on national sovereignty relies on a dichotomised and highly antagonistic view of the relationship between states and the global economy. This perspective is locked into the discursive confines of the structuralist-sceptics debate within the field of international political economy. CRAs are said to either erode state sovereignty or represent a manifestation of it. By abandoning the state-market, public-private and national-global dichotomies embedded within this debate, and the zero-sum mentality they are predicated upon, this thesis offers an alternative – “transformationalist” – perspective to view the power of CRAs and their influence on national sovereignty. Defying traditional categorization, CRAs' power is the result of a state-market, public-private confluence of interest and therefore has no determinative influence on national sovereignty. In the course of this analysis, a second assumption embedded within the study of CRAs' influence is criticised: the fixation on the “big three” rating agencies (Moody's, S&P and Fitch) and the neglect of the significance of the credit rating itself. Because the rating determination process is opaque, and the credit rating itself is a highly simplified expression of an intricately complex financial, economic and political reality, the causes of a sovereign rating change are often “up for debate”. Governments, within certain degrees of interpretation, are able to embed their own domestic political interests into the “causes” of a rating change, thereby co-opting and co-constructing the power and expertise of CRAs. This can, when successful, enhance governments' internal sovereignty over domestic social forces and their external sovereignty as they “filter” the influence of a non-state actor. New Zealand's interaction with the CRAs throughout 2008 to 2012 illustrates how this dynamic occurs and its limitations. The thesis seeks to highlight the diversity and heterogeneity involved in the processes of globalization in general, and CRAs' influence in particular, and in doing so open up political space to consider possible forms of resistance.

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Abbreviations

BIS	Bank of International Settlements	LTCM.....	Long-term Capital Management
BWS.....	Bretton Woods System	M&A.....	Mergers and Acquisition
CDO.....	Collateralized Debt Obligation	MNC....	Multinational Corporations
CDS.....	Credit Default Swap	NMR.....	Non-Majoritarian Regulators
CPE.....	Comparative Political Economy	MPS.....	Mont Pelerin Society
CRA.....	Credit Rating Agency	NBDT.....	Non-bank Deposit Taker
ECAN.....	External Credit Assessment Institution	NGO.....	Non-Government Organization
EKN.....	Embedded Knowledge Network	NRSRO....	Nationally Registered Statistics Rating Organization
ESMA.....	European Securities Market Authority	OECD.....	Organization for Economic Cooperation and Development
EU.....	European Union	OFC.....	Offshore Financial Centre
FCIC.....	Financial Crisis Inquiry Commission	OTC.....	Over-the-counter
FDI.....	Foreign Direct Investment	RAMP.....	Ratings Analysis Methodology Program
FSB.....	Financial Stability Board	RMBS.....	Residential Mortgage-backed Security
GATT.....	General Agreement on Tariffs and Trade	S&P.....	Standard & Poor's
GSE.....	Government-sponsored Entity	SEC.....	Securities & Exchange Commission
HFDA.....	Hedge Fund Disclosure Act	SOE.....	State-owned Enterprise
IMF.....	International Monetary Fund	SPV.....	Special Purpose Vehicle
IO.....	International Organization	STS.....	Science and Technology Studies
IOSCO.....	International Organization for Securities Commission	UNDP.....	United National Development Program
IPE.....	International Political Economy	US.....	United States
IR.....	International Relations	WTO.....	World Trade Organization
ICT.....	Information Communication Technology		

Chapter 1: Introduction

A recent article in *The Guardian* was entitled “How Credit Rating Agencies Rule the World” (Kingsley, 2012). In very few words the article summed up the now widespread perception that credit rating agencies are dominant players in not only international finance, but in world politics more generally. With a number of similar inflammatory remarks emerging regarding the unchecked power and influence of credit rating agencies, a historically and politically informed inquiry into their origins and impact, as well as the nature and extent of their power, is well overdue. Given their now notorious record of failure, most recently illustrated in the Subprime Crisis and arguably the European debt crisis, the authority and resiliency of Moody’s, S&P and Fitch remains somewhat of an enigma for academics.

Despite the central role that credit rating agencies are said to play in global politics, they have been subject to little cross-disciplinary academic study beyond mainstream economics and finance. Most research is restricted to the confines of a rationalist-empiricist epistemology as dictated by neo-classical economics. As Richard Cantor states, the research on CRAs has a “strong empirical focus” (2004, p. 2572). Economists explore which economic indicators cause a change in rating and what the econometrically measured impact of that change is. They thus overlook questions of power and ideology as well as the possible social and political implications of a rating change.

Even following the Subprime Crisis the rating agencies gained little attention from social scientists. As Donald MacKenzie points out, “for all their importance, the credit rating agencies have been the object of surprisingly little social science attention” (2011, p. 1784). Or, as Alexander Cooley notes, “When compared to the amount of research generated on issues such as international trade or international institutions such as the IMF, World Bank or the WTO, our knowledge of the workings and influence of credit rating agencies is remarkably thin” (2003, p. 678-679). All of this suggests that there is a significant unmet need for social scientists to explore the power and influence that CRAs now wield in modern political life. Using both qualitative and quantitative research methods, and drawing from the literature on heterodox political-economics, the central aim of this thesis is to explore two questions: What is the source of CRAs’

power? And what is the impact of this power on the economic policy making autonomy of governments? As will be demonstrated, these two questions are intricately related and cannot be treated separately.

Part 1: A brief history of credit rating

The origins of CRAs lie in the late 19th century with the beginnings of the American railroad companies. Everything about the railroad companies was unique—most importantly their financing. The railroads were probably the largest and most sustained construction program in world history at the time; by the 1890s they accounted for half of all capital nationwide (Panitch & Gindin, 2012, p. 28). Indeed, no other enterprise at the time, or previously, required such large sums of private capital (Abdelal, 2007). Because the American banking system was fragmented during this period it was unable to provide the large sums of capital required for financing the railroads, and the railroad companies had to seek private capital from outside the United States (Sylla, 2002). Yet, as John Moody, a Wall Street analyst during the early 1900s noticed, a distinct lack of information was available to potential investors, who were therefore hesitant to lend. A high percentage of corporate securities were, at the time, being bought on “faith rather than knowledge” (Sinclair, 2005, p. 23).

In an attempt to fill the information gap that existed in the corporate securities market, in 1909 John Moody invented the modern practice of credit rating (Abdelal, 2007). Moody began collecting information on the railroad companies and sold subscriptions to his publication, *Analyses of Railroad Investments*, to potential investors.¹ Rather than being purchased on faith, securities, Moody argued, should be bought on statistically compiled data and objective information. This information would eventually take the form of a credit rating, as John Moody believed that investors would pay for a service that synthesized information into an easily digestible format (Partnoy, 2006, p. 5). It is this easily digestible format -- which coincides with the now socially valorized aesthetic ideals of clarity and parsimony -- that, as chapter 6 will argue, plays a large part in the development and consolidation of CRAs' power.

¹ This investor-pay business model came under pressure in the 1970s when rating became widely available for free on newly introduced electronic communication networks for finance. In an attempt to remain profitable CRAs shifted to the now controversial issuer-pay model in which companies seeking to obtain a credit rating pay the fee, rather than investors who use the information (Kerwer, 2005).

Within a few years other rating agencies began entering the market. Poor's Publishing Company was established in 1916 and was soon followed by Fitch in 1924 (Partnoy, 1999). Rating agencies experienced solid growth up until the mid-1940s. The widespread use of capital controls throughout the Bretton Woods period meant that global private capital flows were minuscule and financial markets were relatively stable. As the amount and riskiness of investment declined, so too did demand for credit ratings. Not until the late 1970s did CRAs return to similar levels of profitability as a result of the major economic shocks experienced throughout the period, which resulted from the abandonment of the Bretton Woods system and the deregulation of financial markets.

Currently two major American companies, Standard and Poor's and Moody's Investors Service, both based in New York, dominate the credit rating market, controlling approximately 80% of market share. Fitch, a French-owned company based in Paris, comes in a distant third. Together these three companies, described as the "Big Three", control a staggering 95% of total market share (SEC, 2012). The credit rating market is thus highly concentrated and contains significant barriers to entry (Hunt, 2008). There are several other agencies active in the United States, and over a hundred operating worldwide. These firms are limited to niche credit markets and specific geographic regions, and thereby hold comparatively little market share (Hunt, 2008, p. 6). Only the Big Three agencies are truly global in scope and broad in their product coverage (IMF, 2010). With around 160 CRAs globally with roughly 4500 employees, the highly influential rating industry is surprisingly small (Langohr & Langohr, 2008). In comparison, for example, the investment bank Goldman Sachs employed 31,700 people worldwide in 2009 (Harper, 2010).

According to Standard & Poor's the function of a credit rating agency is to produce an "opinion on the general creditworthiness of an obligor" (S&P, 2013). For Moody's it is to "provide investors with a simple system of gradation by which the future relative creditworthiness of securities may be gauged" (Moody's, 2013). Thus, credit rating agencies produce forward-looking opinions on the relative likelihood that a debtor or debt-security will default. Ratings refer to credit risk only—the agencies do not claim to provide information regarding either market or liquidity risk. Moreover, the rating agencies are adamant

that their ratings are *subjective opinions* and not a recommendation to purchase, sell, or hold a financial obligation. Ratings are not recommendations to buy as they cannot speak for the risk/reward calculus of the particular investors (Rousseau, 2009). They serve only to comment on the relative likelihood of default. By insisting that credit ratings are opinions, the rating agencies have traditionally been protected in the United States by the constitutional right to free speech, and thus devoid of any legal liability regarding the accuracy of their predictions (Kruck, 2011). However, following the Subprime Crisis the legal regime governing CRAs is in flux. A number of lawsuits are currently taking place where various investors, including the US government, are seeking compensation from the agencies for producing misleading ratings.

On request CRAs issue ratings on municipalities, corporations and sovereign governments.² They maintain ratings on some \$30 trillion dollars worth of debt issued in American and global financial markets (Sinclair, 2005). Issuers request credit ratings as a means to inform potential investors of their creditworthiness so as to improve their ability to raise capital. A good rating theoretically gives the debt-issuer cheaper access to credit in international credit markets. CRAs have therefore been described as the gate-openers of global capital markets as they “literally regulate admission” (Burner, 2007, p. 168). A high credit rating opens up a wider range of funding alternatives in terms of size, length of maturity, geographic market, diversity of instruments and investor base (Langohr & Langohr, 2008, p. 94). In general issuers with a higher credit rating will have a larger pool of subscribers, will be able to sell their debt at a lower cost, and will have lower interest rates on repayments. Sovereign credit ratings also have a substantial indirect impact. Because of the so-called sovereign ceiling incorporated in CRAs’ methodological framework, the rating agencies generally do not assign ratings to sub-state public or private actors that are higher than their government. Even when a sovereign is not issuing bonds, a sovereign rating provides a benchmark for capital markets activities in the private sector (Ratha, De & Mohapatra, 2011, p. 295).

Ratings are displayed in the form of a simple alphanumerical grade, for example AAA or Baa2, with an accompanying modifier (i.e., - or +). While some ratings are confidential, the majority of ratings are

² Rating agencies have been charged with issuing unsolicited ratings but the scale of this is small compared to their solicited counterparts.

published on the agencies' websites and made available to the media and financial market actors (Kruck, 2011). Accompanying a rating is generally, although not always, a short comment giving the reasons for the change. In order to disclose the criteria taken into consideration during the ratings process the agencies periodically publish methodological outlines. This allows those seeking access to capital to know in advance what actions and policies lead to higher ratings. The rating agencies' full statements describing in detail the causes of a rating change are not easily accessible by the public. Access to this information requires a subscription to the agencies' databases; S&P's database is, for example, Capital IQ. Due to the high subscription cost, only large institutions, such as some universities or financial institutions, can afford to subscribe. (Most New Zealand universities are not subscribed.) If an individual wanted to access the full commentary accompanying a particular rating change the cost is \$500 USD per report (Richards, 2013). The general inaccessibility of this information is significant with regard to how we theorize state-CRA relations; as the rationale for a rating change is not made available to the general public, the public is dependent upon either the state or local media to interpret the reasons for the CRA decision.

Credit ratings are used by a wide variety of actors, including investment banks, hedge funds, individual investors and national governments: virtually everywhere in the capital market, investors, issuers, and regulators have come to depend upon these alphanumeric report cards (Langohr & Langohr, 2008, p. iv). The data available to professional actors in financial markets is overwhelming in both scope and quantity, and ratings offer a simplified, easy to use means to understand the risk associated with investment. Due largely to their inherent simplicity, credit ratings changes have also become important public events, even media spectacles. Both the media and the public have begun to follow the rating agencies' judgements (Partnoy, 1999), as evidenced by the media's widespread coverage of S&P's decision to downgrade the US and the highly sensationalized coverage of the agencies' role in the ongoing European debt crisis.

Rating agencies do not simply issue static credit scores, but continue to monitor the development of the associated credit risk. Surveillance of issuers' financial conditions is a key aspect of the rating agencies' work as "creditworthiness is a dynamic condition" (Sinclair, 2005, p. 41). While a rating downgrade, or upgrade, is the agencies' most evident monitoring procedure, it is not the only one. Rating

agencies also issue an outlook – positive, stable or negative – accompanying a credit rating that indicates the likely direction of an issuer’s rating over the medium-term. This surveillance function allows CRAs to promptly react to financial events and changes in economic policy by giving market participants signals regarding possible upcoming changes. By monitoring and evaluating the actions of various financial actors, CRAs establish standardized and centralized criteria identifying what it means to be creditworthy. In order to gain access to private capital, particularly in the sovereign bond market, these standards of creditworthiness must be upheld. Commentators have thus declared CRAs as the “new masters of capital” (Sinclair, 2005, p. 1), and as having a “virtual monopoly on the production of authoritative knowledge surrounding creditworthiness” (Paudyn, 2012). The chapters that follow question such representations of CRAs’ power.

Part 2: Overview and Structure of the Thesis

In order to place the power and influence of CRAs in historical and political context, Chapter 2 will address where power currently lies in the international political economy (IPE). From the 1970s onwards the forces of economic globalization have unleashed what appears to be an historically unprecedented transformation in the interconnectivity of previously nationally based and nationally governed domestic economies. The impact of these changes on the power structure of the IPE is, however, unclear. There is a globalization debate between the structuralists, who see global economic forces as eroding the economic policy making autonomy of states, and sceptics, who insist that states have maintained their supremacy in the international system. The goal of Chapter 2 is to discuss how contemporary theoretical approaches view the impact of globalization on the policy making autonomy of national governments and the assumptions made within these arguments.

The structuralist-sceptics debate is largely mimicked in the debate over CRAs’ influence on government autonomy. The structuralist paradigm is the most common way to view CRAs’ influence over governments, and is summed up by Thomas Friedman: “We live again in a two-superpower world. There is the US and there is Moody’s. The US can destroy a country by levelling it with bombs: Moody’s can destroy a country by downgrading its bonds” (in Sinclair, 2005, p. 1). The downgrading of a state, or the act of

placing it on negative watch, is considered an example of private actors stripping decision-making power away from previously sovereign governments (Sinclair, 2005; Priebe, 2012; Paudyn, 2012). Timothy Sinclair describes CRAs as “eroding the economic policy making hegemony of nation-states” (2000, p. 487). Similarly, Bartholomew Paudyn (2012) describes an antagonistic relationship existing between the expertise of the rating agencies and the politics of fiscal governance; credit ratings, he argues, are “socio-technical devices of control” that promote an artificial fiscal normality, thereby forcing “governments to implement the harsh austerity measures thought to improve their credit score” (2012, p. 17).

Commentary on the agencies by governments and the media has typically maintained this structuralist orientation. When the Italian police raided the offices of Moody's and S&P in August 2011, such drastic action was justified because the agencies were “an erratic danger to state sovereignty in the areas of economics and finance” (Hooper, 2011). Writing for *Al Jazeera*, Michael Marder (2012) describes the role of credit rating agencies within the EU debt crisis: “Formal national sovereignty is of little consequence, when faced with the oracles of the rating agencies that have the power to reduce sovereign credit status to junk.” According to one reporter, “The whole world quakes in the face of credit ratings...most recently the governments of the Eurozone” (Lindner, 2012). David Beers, former head of Sovereign Ratings at S&P, has been described as “the most powerful man in the world that you’ve never heard of” (Kingsley, 2012).

The state-centric paradigm, the sceptics, is the only available alternative to a structuralist conception of CRAs’ power. As discussed in Chapter 4, the rating agencies are considered market-based, yet state-sanctioned, instruments of governance. Frank Partnoy (1999; 2006) argues that the current significance of CRAs is due to their incorporation into financial market regulation. Bruner and Abdelal (2005) argue that the private authority of the rating agencies is not so private after all, as “governments have both valorised and codified their authority” (2005, p. 193). Today, Bruner argues, CRAs’ power “ultimately derives more substantially from state endorsement of their decisions” (2008, p. 131). While the role of the state is noted, this view specifically highlights the role of the US state as the key promoter and beneficiary of this regulatory architecture. Thus, CRAs are generally seen to erode the sovereignty of other, less

significant states. As Bruner & Abdelal note, the rating agencies are “in a position to tell other governments what to do and how to conduct their economic policy in a blunt vocabulary unavailable to the US government” (2005, p. 209).

The power of CRAs has thus been seen in dichotomous terms between the *reputation school* (structuralists) and the *regulation school* (sceptics). The regulation school, as noted above, argues that CRAs’ power is the result of states, largely the US state, incorporating credit ratings into market regulations. Conversely, the reputation school argues that CRAs’ power is a private construction; it has two variants. The first, espoused by economists, argues that the influence of CRAs is predicated on their ability to provide accurate and reliable information on credit risk. The second relies on the notion of private authority and argues that CRAs’ power is based on a socially constructed recognition of their expertise. Both variants share the assumption that CRAs’ power is a private construction and based on reputation: whether social or economic. These views are summarized in Table 1.

Table 1: Traditional Approaches to CRAs’ Power

Sphere of Inquiry	Source of Power	Type of Power	Outcome of power
Economy	Solving the problem of asymmetric information in disintermediated financial markets.	<i>Market legitimacy</i> , a market-based authority as a result of improving market efficiency by providing needed information of credit risk.	Erosion of national sovereignty.
Society	Widespread acceptance of CRAs due to an intersubjective belief in their expertise.	<i>Epistemic authority</i> , consent-based authority drawn from recognized expertise.	Erosion of national sovereignty.
State	Widespread use of credit ratings in financial market regulation.	<i>Delegated authority</i> , a coercive form of authority based on the delegation of a regulatory function.	Strengthening of US sovereignty/erosion of other states’ sovereignty.

The current scholarship on CRAs’ power is firmly located within the confines of the structuralist-sceptics debate. One of the principle aims of this thesis is to move away from the structuralist-sceptics debate embedded in contemporary accounts of state-CRA relations. Both structuralism and scepticism are outlined in order for the reader to appreciate the differing perspectives, but also, and more importantly, to understand the assumptions upon which these theories are built. The goal is to deconstruct the prevailing terms of debate set by the structuralist-sceptics debate and construct an alternative theoretical framework

with which to view CRAs' power. Deconstruction is necessary because, as Kyle Grayson points out:

[A]ll fields of knowledge and their associated discourses are defined and redefined by internal debates. However, the actual space for debate may be far more limited than is commonly understood at first appearances. Discourses construct both the boundaries of conversation and the resulting accounts of reality by stealth... 'disagreement' hides the shared allegiances to deeper structures of thought that contain their disagreement. (2008, p. 37)

Deconstruction plays an emancipatory role by unsettling what are taken to be stable concepts and conceptual opposition within a field of debate. The shared assumptions embedded within the structuralist-sceptics debate are the theoretical dichotomies between the state and the market, the public and private, and the global and the national. Each sphere is considered separate to, and distinct from, the other. The transformationalist perspective put forward avoids such dichotomous thinking. It argues that the state/market, public/private and national/global are not separate entities with their own path-dependencies, but are joined in "loops of codetermination and coevolution" that "make up" the economy and the processes within (Pryke & Paul du Gay, 2007, p. 343). In deconstructing the source of CRAs' power, their influence on governments is also questioned. If CRAs' power results from a complex intermeshing between public and private forces, their influence on government policy cannot be stated determinatively, but is context-bound and indeterminate.

CRAs' power is not solely a manifestation of American state interest, nor, however, is it entirely a private construction. Rather, when viewed from the transformationalist perspective, an interaction occurs between states and rating agencies. This interaction takes the form of *both* a deliberate transnational class project – such as that outlined by Gill's (2008) perspective on globalizing elites – and an unconscious, non-deliberate co-construction arising from a complex interplay between state and market forces. This draws from both the Foucauldian and neo-Marxist literatures on changing forms of governance. Neither argument is sufficient without the other. Co-construction arguments cannot adequately account for the conscious alliance of interest that has developed between globalizing elites and the rating agencies, and its manifestation in the national and transnational regulatory incorporation of credit ratings. On the other hand, globalization is not simply a transnational political project, but a dispersed mentality of governing:

one driven by the social beliefs, desires and expectations of individuals. Theories of elite-driven globalization become problematic as they disavow the everyday life of global transformations: that is, the way in which aspects of normal daily life contribute to processes of change and power in the global economy (Langley, 2008).

As state-market relations are viewed as an interaction, the global economy represents both a possible opportunity and a possible constraint to national sovereignty. As an example, Hay and Smith (2005) describe the use of global discourses, such as occurred in the Blair government's strategic use of "no alternative" logic, to justify domestic policy changes. Through an exploration of various appeals to the globalization process in the UK, what becomes apparent is the highly strategic ways in which global discourses are used within the domestic setting. In acting as if globalization were true, policy-makers may actually create the very outcomes they attribute to globalization itself (Hay & Smith, 2005). Constructing the appearance of state decline and the rise of private power is a means by which governments can avoid demands for political accountability. As will be argued, governments can invoke the power of CRAs and the "threat" of a rating downgrade for similar purposes. As the New Zealand case study demonstrates, by acting as if credit rating agencies are powerful, governments can create the very outcomes they attribute to the CRAs.

The downgrading of Victoria, Australia in October 1992 is an example of this dynamic occurrence. The newly elected government was able to use the downgrade to great political effect. The two-notch downgrade, as Hayward and Salvaris argue, helped create the perception of a debt crisis and that there was "no alternative" to fundamental policy change (1994, pp. 1-26). This allowed the new state government to get public support for its tough approach to the budget. The rating agencies gave the state government the means to externalize and objectify its policy agenda, thus "vastly reducing the government's democratic accountability over its budget" (Sinclair, 2005, p. 103).

The political attention given to the CRAs in Australia has not subsided. In 2003, Kevin Foley, the Treasurer of South Australia, publicized his self-imposed mission to restore the state's AAA rating: "After his

2003 budget Foley had suggested that a triple A rating from international credit rating agencies ‘should be the goal of every treasurer’...His enthusiasm and commitment to regaining the top rating was undiminished in 2004 leading to the media’s description of a ‘grand obsession’ in pursuit of a ‘fiscal holy grail’” (Anderson, 2004, p. 3). The self-imposed nature of Foley’s quest leads Anderson to the conclusion that credit ratings were being used as part of the state’s “political communication strategy both externally to the electorate and internally to the public sector” (Anderson, 2004, p. 6). While Anderson makes this astute observation, he nonetheless reverts back to prevailing theoretical sentiment in which CRAs are seen to erode national sovereignty. Questioning the presumption of state-CRA antagonism, this thesis will argue that by using credit ratings as a strategy of political communication, governments can potentially enhance their internal sovereignty over the local population. By contributing to the discursive construction of CRAs’ expertise through various public statements, governments can legitimise and externalize the necessity of implementing certain domestically unpopular policies. Also, as will be discussed, governments can strengthen their external sovereignty by selectively interpreting CRAs’ recommendations and thereby *filtering* the influence of a private, non-state actor.

Chapters 3, 4 and 5 will critically examine the traditional approaches to CRAs’ power (as found in Table 1) with regard to their referent sphere of enquiry: the market, the state and society. The goal is not to study these categories as separate entities existing independently from one another, but to highlight how these spheres are always bound together, influencing one another, yet not simply reducible to each another (Cox & Sinclair, 1996). The aim is to emphasize how an assemblage of social, political and economic factors contributes to CRAs’ power. No single approach, it is argued, can adequately explain CRAs’ power.

Chapter 3 discusses how changes in global financial markets have increased the demand for credit ratings. It argues, contrary to some neo-classical economists, such changes are a necessary but not sufficient factor for explaining CRAs’ power. Chapter 4 explores how states have been involved in the empowerment of CRAs by incorporating them into financial market regulations. The limitations of this state-centric view are pointed out by highlighting cases where, despite a lack of regulatory pressure, credit ratings are still granted considerable weight. Chapters 5 and 6 focus on the social dimensions of CRAs’ power. The

question of how CRAs have created and maintained an intersubjective consensus in their expertise has been insufficiently explored by academics. After critiquing current arguments that focus on CRAs' endogenous status within financial markets, Chapters 5 and 6 argue that the overly-simplified form of the credit rating and the quantitative methodology said to underpin it generate a belief in its objectivity and neutrality.

In looking at the social dimensions of CRAs' power, Chapter 6 shifts attention away from CRAs and towards credit ratings. In traditional accounts of CRAs' influence over governments there is no mention of the particular means through which the rating agencies' judgements are transmitted to, and made influential in, sovereign states. CRAs are said to affect government autonomy, but the details of this process are often neglected. As Susan Strange argues, "knowledge is power...and whoever is able to develop or acquire a kind of knowledge that is sought by others, and whoever can control the channels by which it is communicated...is able to dominate" (1987, pp. 569-570). The power of knowledge therefore has two components: who creates knowledge and how that knowledge is then communicated. Current studies of CRAs focus on the former whilst paying insufficient attention to the latter.

In an effort to combat this theoretical deficit, Chapter 6 discusses the unique characteristics of the credit rating form. Key to this is the dynamic of *uncertainty absorption*, which results from credit ratings reducing the vast complexity of creditworthiness into a simple alphanumerical form. As will be argued, this dynamic, combined with the highly opaque nature of the rating process and the general inaccessibility of the full rating reports, puts into question CRAs' roles of unproblematically transmitting their policy orthodoxy. The travel of ideas, or in this case rating orthodoxy, is an active process of translation. Domestic political actors, within certain limits, are able to embed their own interests and political preferences into the information being communicated. In highlighting certain characteristics of the rating form and the complexities involved in the communication of credit judgements, there are specific repercussions for how we theorize state-CRA relations. Changes in credit ratings essentially become *up for interpretation*.

Chapter 7 introduces the New Zealand case study. In discussing New Zealand's program of neoliberal reform, which commenced during the mid-1980s, two key dynamics become apparent. First, the

state played an instrumental role in the initiation and implementation of the neoliberal reforms. The New Zealand experiment was not a necessary response to material global economic forces, but a domestic political construction. Second, the strategic use of a globalization discourse and the selective interpretation of international recommendations were key strategies used by the New Zealand government to legitimize and advance the neoliberal reform process. This is used to illustrate how governments can interact with private actors to enhance their policy autonomy. Chapter 7 also discusses how the market reacted to changes in New Zealand's sovereign credit ratings. By demonstrating the relative insignificance of credit rating changes to the New Zealand government's bond yields and exchange rate, the social and political dimensions of CRAs' power are further brought to light.

Focusing on social and political dynamics, Chapter 8 discusses the interactions that occurred between the New Zealand government and the CRAs between 2008 and 2012. Throughout this period the CRAs played a highly significant role in New Zealand politics, specifically around economic policy debates. Illustrating the interpretable nature of rating changes, throughout this period the National government took significant liberties when interpreting the causes of, and suggested policy responses to rating changes. What was also noticeable was the highly selective and strategic way in which credit ratings were invoked by the government. Credit ratings were referred to variously as subjective opinions or objective facts in an effort to either increase or decrease their authority as a matter of political expedience. When National disagreed with the agencies' policy recommendation such judgements were often lost in translation.

The goal of this thesis is not to imply that states dictate how and when CRAs' influence government policy. Rather, the goal is to emphasize the complexity of state-CRA relations, which do not fit comfortably into the sceptics or the structuralist theoretical framework. State-CRA relations can be both potentially cooperative and conflictual. In emphasizing the diverse and varied way in which CRAs' influence government policy, the aim is to criticize the assumed structural uniformity of CRAs' power over governments and the broader set of agencies that constitute the state. By exploring the particular processes by which CRAs become influential in a domestic setting, the specificity and contingency of CRAs' power is

illuminated, and so too is the often neglected role of states in the discursive construction of the CRAs' power and expertise.

Chapter 2: Power in the International Political Economy

Introduction

The international system is less commanding, but still powerful. States are changing, but they are not disappearing. State sovereignty has been eroded, but it is still vigorously asserted. Governments are weaker, but they can still throw their weight around. (Rosenau, 1997, p. 3)

James Rosenau captures the ambivalent status of the sovereign state in what appears to be an historically unprecedented era of globalization. Rosenau's indeterminacy is echoed in the wider debate regarding the status of state sovereignty in the contemporary era. The defining question within this debate is: what is the impact of globalization on the policy autonomy of governments, along with the broader set of agencies and public bodies that constitute the state? Seeking to explore this question, this chapter asks: what is globalization and what are the consequences of its rise to prominence? Is globalization eroding state sovereignty and diminishing the power of governments to autonomously govern national economies? Conversely, is globalization a myth, an ideological construct designed simply to placate domestic constituencies and enhance the interests of the most powerful states?

According to David Held and his colleagues, globalization is "an idea whose time has come", and the "cliché of our times" (McGrew, Goldblatt & Perraton, 1999, p. 1). For Keohane and Nye, "this vague phrase expresses a poorly understood but widespread feeling that the very nature of world politics is changing" (2000, p. 104). The conceptual ambiguity surrounding this buzzword has come to hinder rather than aid academic inquiry. Existing definitions of globalization remain steeped in ambiguity and inconsistency; some include: accelerating interdependence (Ohmae, 1990), time-space compression (Harvey, 1989) and the widespread perception of global interconnectedness (Pauly, 2002). Globalization is a multi-dimensional project with social, political, economic and cultural aspects. Any attempt at capturing such all-encompassing logic and producing a usable definition is thus doomed to fail, and also "delivers little substantive insight into the contemporary human condition" (Held et al., 1999, p. 1).

Following such insights, globalization here will specifically refer to neoliberal globalization. While

globalization has become an extremely broad concept, when expressed as neoliberal globalization its meaning becomes clearer (Gills, 2004). Neoliberal globalization denotes the transnationalization of a political-economic system that espouses the market as the superior mechanism of socio-economic and political organization.³ Neoliberal globalization is intricately bound up with both globalization and state restructuring. Jamie Peck and Adam Tickell describe neoliberalism as “the dominant ideological rationalization for globalization and contemporary state reform” (2002, p. 380). As such, the processes of globalization, neoliberalism and state transformation are intricately bound together.

There has been considerable debate regarding the cause(s) of neoliberal globalization. Four approaches are prominent within the initial scholarly reaction. Firstly, an approach with roots in neo-classical economics depicts market forces driven by revolutions in information communication technologies (ICT), as having swept away institutional and legal barriers to market integration and the free flow of capital. The second approach stresses the instrumental role of states and state policies in the process of economic globalization. Thirdly, the role of domestic political processes and institutions is highlighted. And finally, ideational factors are given causal significance, stressing the role of belief systems and epistemic communities as catalysts for change (Cohen, 1996). Much like the debate over the impact of neoliberal globalization, the focus lies either on the market, the state and domestic institutions or the role of ideas, and each is problematically understood as separate to, and independent from, the other.

The debate over the impact of neoliberal globalization on the state has been framed in similar dichotomous terms. As noted, it is between structuralists, who see global economic forces as disciplining, if not eroding, the economic policy making autonomy of the nation-state, and the sceptics, who insist that states have agential power—the ability to mitigate the effects of global forces and shape global economic structures. A third position has recently emerged. Termed transformationalism, this perspective argues that the dichotomy between the state and global economic forces is false.⁴ The state is neither eroding nor has it

³ As each theoretical approach discussed here highlights different aspects and processes associated with neoliberalism, a comprehensive definition of neoliberalism will be given in the final section.

⁴ These three theoretical approaches to globalization have been described as the three waves of the globalization debate (Hay & Marsh, 2000). Yet, the descriptive terms of structuralist, sceptics and transformationalist (as used in Held et al., 1999) are preferred as they reject any underlying narrative of progress embedded within the wave

remained unchanged; rather, it is transforming. States have not declined as a result of global economic forces, they have expanded. Commenting on the first great wave of liberalization throughout the 18th and 19th centuries, Polanyi argues that, “The road to the free market is opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism [by the state]” (Polanyi, 1944, p. 140). The processes of neoliberal globalization are embedded within state structures, contingent on state policies, and primarily defined by the reorganization of the state (Amoore et al., 1997).

The debate between these positions entails not only substantive debate regarding the impact of neoliberal globalization on the state, but also the appropriate methodological, ontological and epistemological foundations necessary for the study of international political economics. The substantive debates have asked: Are global economic pressures leading to an increasing convergence (or divergence) of national economic policy? Is the changing nature of the global political economy leading to the transfer of authority from the state to private actors? Are systemic forces disciplining the state, or is the state an active agent shaping global economic structures? Among the issues explored in methodological, ontological, and epistemological debates are: What is the relationship between the economic and political domains? Are markets and politics mutually constitutive or separate spheres of human activity? Should the domestic and international spheres continue to be treated as separate levels of analysis? What is the appropriate unit of analysis: should nation-states or global systems and processes be the main focus of academic inquiry? Finally, is quantitative data sufficient to capture global political-economic trends, or is a more qualitative and holistic method necessary?

The central aim of the thesis is to explore how CRAs impact the economic policy making autonomy of governments. As the debate is between those who believe CRAs are eroding state sovereignty and those who believe they are a manifestation of it, it neatly fits into the sceptics-structuralist debate. This literature review of the sceptics-structuralist debate provides the underlying theoretical context for the CRA debate. The transformationalist framework, it is argued, provides a more fruitful perspective from which to view the state-CRA relations. Within this chapter the structuralists’ position depicting the decline of the state will

first be presented, highlighting in particular the rise of private power in international affairs. This is followed by a presentation of the sceptics' position that includes a combination of realist international political economy (IPE) and comparative political economy (CPE). Finally, transformationalism, and its relation to neoliberalism, will be discussed.

Part 1: Global Economic Forces and the Decline of the State

Structuralists argue that global economic forces are eroding the social, economic and political foundations of the state. Three points are central to their argument: there has been a shift in the dominant pattern of socio-economic organization away from the territorial confines of the nation-state; power is shifting from state to non-state actors; and there has been a convergence in national economic policies around neoliberalism and an ensuing retreat, or hollowing out, of the state. Strange sums up this theoretical trend: "The impersonal forces of world markets are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong. Where states were once masters of markets, now it is markets which, on many critical issues, are the masters over the government of states" (Strange, 2000, p. 128).

While the erosion of the state thesis initiated this theoretical trend, it is now considered the constraint school. This school argues that neoliberal globalization is weakening the capacity of states to autonomously govern their national economies. Structuralism contains a positive variant that includes proponents of neoliberal economic policies (O'Brien, 1992; Ohmae, 1990), along with a more pessimistic school who remains its critic (Strange, 1996; Camilleri and Falk, 1992). Despite differing ideological convictions there is a shared belief that globalization is largely an economic phenomenon; that an integrated global economy exists today; and that the needs of global capitalism impose neoliberal economic discipline on all governments (Held et al., 1999). These approaches are thus descriptive accounts concerning the impact of neoliberal globalization, not normative statements regarding its desirability.

In the traditional Westphalian state system the state was said to be the basic unit of economic governance, defined by mutually exclusive geographic jurisdictions (Kobrin, 2002). The period ranging from

1945 to 1975 has been labelled the Golden Age of the welfare state and national economic policy autonomy. While it would be wrong to speak of purely closed national economies, in the post-war decades, states, using a variety of protectionist economic policies, were able to control their own economic boundaries and the conditions under which transnational economic transactions could take place (Scharpf, 2000). By the 1980s, however, things began to change. In many states and especially in large and influential ones, capital markets were liberalized, financial markets deregulated and currencies were allowed to float. This, structuralists argue, unleashed a wave of economic globalization that has weakened the state's centralized role in economic governance.

A spatial disjuncture is now said to exist between territorial sovereignty as the organizing principle of world politics and the increasingly global structure of markets (Amoore et al., 1997). The principle of territorial sovereignty, along with traditionally state-based instruments of economic governance, assumes a direct correspondence between economy, society and polity, all of which are said to exist within an exclusive and bounded national territory (Held & McGrew, 2003). Economic globalization, structuralists argue, has disrupted this correspondence as economic activity is no longer confined to the state (Cerny, 1995). As markets grow beyond the regulatory jurisdiction of the nation-state the management of economic processes becomes increasingly difficult, if not impossible.

The increasingly deterritorialized nature of communication networks and finance capital has meant the state can no longer claim exclusive territorial jurisdiction. The revolution in ICT, financial liberalization and increasing capital mobility has meant "geographic location no longer matters in finance" (O'Brian & Keith, 2009, p. 1). Developments in ICT are "altering the dimensions of markets...and destroying those barriers around markets that hitherto have been synonymous with specific geographic coordinates (O'Brien, 1992, p. 97). As Karl Marx argued a number of years ago, "Capital by its nature drives beyond every spatial border...to conquer the whole earth for its market" (in Scholte, 1997, p. 433). The rise of offshore financial centres (OFCs), for example, illustrates states' growing inability to govern economic activities. Offshore space offers (typically virtual) sites in which global economic actors can bypass traditional sovereign demands for disclosure, regulation and taxation (Palan, 2006). By offering such services these microstates

effectively undercut the traditional sovereign state's ability to exercise its regulatory tasks and capture rents (Cooley, 2003, p. 679).

As corporations become internationally mobile their ability to shift production and investment overseas has meant they now wield considerable amounts of power over governments. For David Andrews, capital mobility "systematically constrains state behaviour, rewarding some actions and punishing others" (1994, p. 193). Capital exists for the sole pursuit of profit and as such, *ceteris paribus*, it will exit high-taxation regimes for low ones, highly regulated labour markets for poorly regulated ones, and strong welfare states for weak ones. In order to access finance and gain competitive advantage states must compete for footloose capital and in doing so must constantly strive to improve their investment climate by internalizing the preferences of transnational capital.

The preferences of capital are said to be antithetical to good domestic labour conditions, social welfare spending, financial stability and interventionist development models (Gill & Law, 1988, Ch. 8). Thus, a so-called race to the bottom ensues, inciting a wave of deregulatory arbitrage in which states remove domestic regulatory standards in order to compete for transnational capital.⁵ Witnessing these trends, the director of UNCTAD observed that under the forces of globalization, "the role of government is progressively shifting towards providing an appropriate enabling environment for private enterprise" (in, Scholte, 1997, p. 446).

Developments in the international financial markets, specifically governments' increased reliance on raising capital in bond markets, have meant international investors have gained a significant degree of influence over government policy (Underhill, 2000). The ability of governments to raise funds at a reasonable cost has become increasingly dependent upon the willingness of private monetary agents to buy and hold public securities (Germain, 1997). Furthermore, the integration of financial markets has undermined the macro-economic autonomy of nation-states. The traditional tools of central banks have

⁵ The phrase "race to the bottom" encapsulates the movement in which far from promoting social welfare through the accumulation of capital, the very attempt to attract capital has a disastrous impact on workers' rights and the protection against the inflationary and destabilizing effects of 'hot money'. Individuals' protection, security and well-being are sacrificed to facilitate a more attractive investment climate.

been rendered obsolete; interest rates, exchange rates and money supply are all set in the global marketplace (Ohmae, 1990, pp. x-xi).

A diffusion of authority is taking place in the global economy. The role of economic governance is being stripped away from governments and towards a heterogeneous group of private corporations, supra-national organizations, regional trading blocs and non-governmental organizations (NGOs), thereby constituting a heterogeneous distribution of regulatory power to differing centres of action within the global economy. In the interest of economic competitiveness and growth, nation-states have yielded a substantial amount of their domestic regulatory authority to transnational regimes and organizations (Lipschutz & Fogel, 2002). NGOs, for example, have become instrumental in the formation of a number of private transnational regimes (Lipschutz & Fogel, 2002), taking on functions generally performed by government regulatory programs (Meidinger, 1999). Regional trade agreements, for example, have shifted power away from states and diluted the policy making capacity of governments. As Morales comments, NAFTA has “moved policy making from the realm of states and government agencies to that of private business” (1997, p. 427).

A transformation is taking place not only in the size and scale of government, but in its basic form (Bell & Hindmoor, 2009). Premised on the idea that governance need not require governments, these authors argue that the principle mechanism of governing in modern society has shifted from *government* to *governance* (Reinicke, 1998). These new modes of governance are largely expert-based, increasingly legitimized by reference to science, expressed in terms of measurement (Miller & Rose, 2008) and are described as eroding the economic policy-making hegemony of nation-states (Sinclair, 2000). The relative disempowerment of public authorities in regulatory processes results from a lack of both information and expertise as driven by the massive accumulation and concentration of wealth in the private sector (Underhill, 1995). Additionally, the temporal compression of global economic space has greatly exacerbated the resources needed to adequately govern economic activities. As Underhill and Zhang argue, “with their control over knowledge and expertise...powerful private actors have become key players in emerging transnational policy processes” and are in a strong position to set the agenda for national economic policies

(Underhill & Zhang, 2008, p. 541).

The final component of structuralism is the global ascendancy of neoliberalism as a hegemonic paradigm of state restructuring and economic management. An ideological consensus has emerged within the states of the developed world regarding the superiority of market-based mechanisms of economic governance over the apparently crises-ridden state-based ones. With the collapse of state-socialist regimes in the late 1980s and early 1990s, liberal commentators declared the death of the “last remaining alternative to capitalism” (Fukuyama, 1989). The dismantling of the welfare state and the privatization of state assets undertaken in most developed-world states are the manifestation of these beliefs and are often described as the hollowing out of the state. As neoliberalism considers the market superior to any other form of organization, its global spread has reduced the legitimacy of broad state involvement in the economy, and thus reduced governments’ ability to shape or protect against market outcomes: “Waves of deregulation...have swept away governmental power virtually across the world” (Berger, 2000, p. 51). The end-result of this process is to place traditionally public decisions into the hands of the private sector.

According to Philip Cerny (1990) and others, the rise of neoliberalism, along with the greater structural interpenetration of national economies, is leading to the emergence of a competition state: the privatization, marketization and commodification of the state and state activities. Leftist parties in France, Australia and New Zealand, among others, have all moved considerably away from their traditional economic strategies and instituted neoliberal reform programmes (Gill, 2008). The notion of public interest has undergone a profound change. The aim of social justice through redistribution has been challenged by the marketization of the state’s activities (Cerny, 2010). The provision of public goods has shifted away from the general maximisation of welfare through state intervention, towards the promotion of enterprise, innovation and profitability (Cerny, 1990). The result is the erosion of the public sphere as traditional state functions and assets are transferred to the private sector (Jessop, 1997). As Barry Gills argues, “The main historical thrust of neoliberal economic globalization is to bring about a situation in which private capital and ‘the market’ alone determine the restructuring of economic, political and cultural life, making alternative values or institutions subordinate” (2000, p. 5)

Emerging in opposition to the structuralist claim that the state is being fundamentally eroded by global economic forces, the sceptics argue that the state has retained its decision autonomy. Key to this argument is the empirical observation that global economic integration is not as complete, nor all-encompassing, as the structuralists proclaim; the transnational mobility of capital and its ability to discipline policy-makers into adopting certain economic policies has been exaggerated. How the sceptics justify this argument and why the belief in capital mobility has become so embedded in common-sense are questions, among others, that will be addressed in the following section.

Part 2: The Sceptics and the Myth of Globalization

Composed of a heterogeneous group of realist international relations (IR) scholars and comparative political economists, the sceptics argue that the state is still the central decision-maker in international economic affairs. As Robert Gilpin states, “the effects of globalization on the nation-state have been considerably exaggerated...it is still a state dominated world” (2001, p. 345). Relying largely on quantitative data, the sceptics argue that current levels of economic integration are not historically unprecedented and remain comparatively lower than earlier periods of globalization (e.g., 1870-1914). Economic integration is highly uneven and concentrated within a few Western industrial countries; the global economy is therefore still largely an *inter*-national system dominated by distinct national economies. Moreover, the internationalization of markets is not the outcome of unrestrained market forces, but the purposeful action of states.

Traditional IR realism has been a significant component of the sceptics’ backlash against structuralists’ accounts of globalization. While structuralists argue that economic forces are now the basic determinant of social and political organization, political realists maintain the primacy of the political; political forces determine economic outcomes not *vice versa*.⁶ As Gilpin argues, “Although the economic and technical substructure partially determines and interacts with the political superstructure, political

⁶ Gilpin, making this point, critiques Friedrich Engel’s argument in *Anti-Duhring* that economic forces were the primary factor determining the unification of Germany. Criticizing such economic reductionism, Gilpin argues that the union was engineered by the Prussians “primarily for political purposes...in order to gain hegemony or at least influence over the lesser German states” (1971, p. 402).

values and security interests are crucial determinants of international economic relations” (1971, p. 403).

Politics, Gilpin (2000) argues, determine the framework of economic activity and channel it in directions that serve the political objectives of dominant political groups. In 1954 E. H. Carr argued that an international economy based on free trade was not a natural or inevitable state of affairs, but reflected the economic and political interests of Great Britain (in Gilpin, 1971). The most powerful states actively construct economic orders to serve their own interests. The self-interested policies pursued by the US and British governments were instrumental in the creation and development of the modern financial system (Helleiner, 1996). American policy deliberately promoted norms and institutions such as the GATT, the World Bank, and the IMF that created an open international economic system (Nye, 2003, p. 112).

Financial globalization has not led to an overall decline in state regulatory power over finance. Rather, it appears to have encouraged states to enhance their power in new ways that are more domestically intrusive and often introduced in an internationally coordinated fashion (Helleiner, 1999). Following the initial destabilizing impact of financial deregulation and capital account liberalization, there has been a shift towards the re-regulation of the banking and finance industries, which seeks to “bolster, rather than undermine, the power of the state to regulate its own markets and financial institutions” (Helleiner, 1999, p. 144).⁷ States’ widespread adoption of the Basel Capital Adequacy requirements is an example of competitively-driven re-regulation.⁸ Such efforts at financial re-regulation, whilst rather unsuccessful – as evidenced by recent global financial turmoil – illustrate how states are increasingly involved in processes of economic governance and that competitive pressures can lead to re-regulation, rather than simply deregulation.

Realists argue that we should not confuse the act of giving away control with losing control. Paul Hirst notes, “Global markets are by no means beyond regulation and control, even though the current scope and objectives of economic governance are limited by the divergent interests of the great powers and the

⁷ Examples include: the Bank of International Settlements (BIS), the Basel Accord and the Financial Action Task Force.

⁸ Capital adequacy requirements are standards developed by the Basel Committee that stipulate the amount of capital a bank or other financial institution must hold with the aim being to limit the risk exposure of banks.

economic doctrines prevalent among their elites” (1997, pp. 2-3). Simply because the state has chosen to give away some control over economic affairs does not impact its sovereign status. Only when non-state actors are able to maintain control over economic affairs following a conflict with the state can it be argued that the state is no longer sovereign in that domain; the sovereign decides on the exception, not the rule (Schmitt, 1922).

Rather than economic globalization constraining state capacity, it can be argued that it has enhanced it (Weiss, 2003). As governments have always faced difficulty raising funds from their domestic tax base, and they are now aware of the perils of inflation, they have shifted away from printing money and towards borrowing money in international bond markets. The OECD average debt-to-GDP ratio was 72.8% in 2011 (OECD, 2011). Access to credit in international capital markets has allowed governments to pursue expansionary economic policies and finance fiscal deficits that they would otherwise not be able to (Garrett, 1995). Helleiner, drawing on an example from European history, argues that “in an era when states often lacked the ability to collect domestic taxes in an efficient manner, loans from international financiers were in fact a central way in which states mobilized money to consolidate their sovereign power and authority” (1999, p. 148).

Structuralists, Gilpin argues (2002), contrast economic policy in the 21st century to an imagined past where states had unrestricted ability to determine economic policy. State autonomy has never been absolute; it has always been constrained by international economic transactions that remain an inherent element of any international system (Krasner, 1999). States have continually attempted and continually failed to successfully govern economic activity.⁹ Levels of economic autonomy under the Gold Standard were actually much lower for advanced economies than they are today (Krasner, 1999). Adherence to the rules of the Gold Standard meant that countries had to subordinate their domestic economic policy to a rigid set of international rules (Hirst & Thompson, 1999). The trade-off between efficiency gains from cross-

⁹ The consistent failure to control capital movement is an example. During the mercantilist period most European states sought to control the international movements of precious metals; these initiatives were rarely successful. Moreover, attempts during the 1940s and 1950s to use capital controls were rarely successful. Finally, recent attempts at regulation have been overwhelmed by offshore financial centres and money laundering activities (Helleiner, 1999, pp. 138-139).

border economic activity and autonomy is far from new, and historic experience indicates that governments often favour the former (Keohane & Nye, 1989).

The race to the bottom thesis argues that international competition is leading to deregulation, the decline of the welfare state, and overall a diminished role for the state in matters of economic governance. These propositions have been criticized by a number of scholars. While deregulatory competition has been a strategy adopted by some states, it is by no means hegemonic, nor the only available policy response (Berger & Dore, 1996). Global competition can also produce a race to the top. As Susan Berger argues, “low real wages paid to badly trained workers are not the only attraction for inward investors. It is also possible to attract them with crime-free streets, with high-quality education and training, and with a clean environment” (in Mosley, 2003, p. 9). There is, indeed, a positive correlation between levels of economic integration and government expenditure (Hirst & Thompson, 1999, p. 166).

The disciplinary power attributed to the modern corporation relies on the assumption that firms are internationally mobile. While firms can reduce labor costs by moving their activities offshore, they also gain distinct competitive advantages from a national economic base.¹⁰ Social policies can “offer distinct institutional advantages to employers” (Hall & Soskice, 2001, p. 50). The comparative institutional advantages of home-centeredness tend to render companies less mobile than conventional wisdom dictates, and it produces various downsides to firms becoming truly transnational (Hall & Soskice, 2001). The largely localized sales and asset bases of multinational corporations (MNCs) mean they have a strong interest in the prosperity of their home base. As Hirst comments, “far from having escaped the constraints of national jurisdictions most firms remain firmly embedded within particular nation-states” (1997, p. 419). Governments therefore retain significant bargaining power over corporations.

Capital markets are commonly assumed to be both truly global and perfectly integrated (Hay, 2007). Sceptics, however, argue that by most measures the levels of integration accompanying the first global economy compare favourably with that of the current one (Gilpin, 2000; Krasner, 1999). Trade, investment,

¹⁰ Examples include; the facilitation of inter and intra-firm cooperation, low-cost infrastructure, R&D assistance, and a nationalistic culture as a focal point of identification necessary for group cohesion (Hirst, 1997; Hirst & Thompson, 1999, p. 272).

and financial flows were greater in the late 1800s (relative to the size of domestic economies and the international economy) than they are today (Gilpin, 2001, p. 364).¹¹ Integration in the world economy is highly uneven, restricted to particular economic sectors, and not nearly as extensive as many believe. The center of gravity of many of the transactions we refer to in an aggregate fashion as the global economy lies in the North Atlantic region: the data for foreign direct investment (FDI) clearly illustrates that the United States and the EU are the major receiving and sending areas in the world (Sassen, 2000). In addition, investment itself is still characterized by a powerful home bias, with 80% of investment in larger countries from domestic investors (Sassen, 2000).

The integration that is occurring is largely based in geographic clusters. The Triad of Europe, Japan and North America have dominated world trade and financial flows (Hirst & Thompson, 2009). China has also recently become a member of this elite club, and it is now second only to the US in terms of attracting FDI (Westad, 2012). The regionalization of the world economy, as witnessed in the proliferation of regional trade agreements, represents the growing segmentation of the world economy into a multiplicity of regional economic zones dominated by national economic interests (Hirst & Thompson, 2003). Regional trade agreements are not stepping-stones to a fully integrated global economy; they represent policy instruments designed to resist the forces of globalization and preserve national policy autonomy (Mittelman, 2000).

The preferences of transnational capital have been problematically taken from prevailing neo-classical economic assumptions, in which capital reflects a narrowly Anglo-US conception of competitiveness. The idea that economic benefits accrue to corporations as a result of a deregulated market environment is odd given that market volatility, instability and unpredictability—all ubiquitous within a deregulated environment—serve to hinder rather than aid profit margins (Hirst & Thompson, 1999, p. 272). As Colin Hay (2007) argues, there is no prior reason to hold generous welfare states and high

¹¹ Due to length constraints the specifics of the data used by these authors will not be explored. It must be noted however that the data used, and the conclusions drawn from it, are contested. As Held and McGrew argue, there exists a “multiplicity of data sources on diverse global trends”, and this has meant that “discussion [often] revolves as much around conflicting assessments of the validity of existing evidence and the value of different types of data as it does around issues of theoretical interpretation” (2003, p. 19).

corporate taxation burdens as being incompatible with the attraction and retention of foreign direct investment. Not only have the most generous welfare states consistently proven the most attractive for inward investment, but also volumes of FDI are positively correlated with levels of corporate taxation, labour costs and degree of labour market regulation (Hay, 2007).

Consideration of government policies by investors is said to lack uniformity and vary considerably between countries (Mosley, 2003). Not all international investors are equally sensitive to monetary or fiscal changes in host countries (Maxfield, in Mosley, 2003). Different financial systems are made up of different institutions and arrangements and thus operate with varying calculative modalities. The result is a continued diversity of expectations and outlooks, which cannot be reduced to a single global market place or logic (Hirst & Thompson, 1999). As Mosley notes, “if domestic constituents prefer and are willing to fund larger public sectors, financial markets do not punish governments for acceding to this demand” (Mosley, 2003, p. 749).

Due to their distinct social and institutional particularities, states are able to filter, if not resist, the pressures exerted by global economic forces. The ability of the state to both preserve and implement distinct, nationally-based, development models can be found in the literature on new institutionalism (Hall & Soskice, 2001).¹² Contrary to notions of convergence, there are distinct capitalist social formations – the European social-democratic mixed-economy, neoliberal Anglo-American capitalism, developmental state models as seen in East Asia, and more recently the Beijing Consensus – all of which continue to exist and in some cases flourish (Halper, 2010; Wade, 1990).

Very little convergence has taken place at the level of national institutions (Gilpin, 2002). While external pressures may require some response, the character of the response is largely determined by domestic factors and is not limited to a single option (Gilpin, 2000, p. 345). As Garrett argues, “The effects of globalization are intermediated by domestic politics...different partisan alignments, social alliances, and national ideologies, [all of which] produce different programs” (in Berger, 2000, p. 10). Most contemporary

¹² The aim of which was to bring institutions back in to both the study of globalization, and indeed, capitalism more generally.

accounts of convergence through best-practice fail to analyze the principal mechanism and process through which learning-driven convergence is said to take place (Gertler, 2001). Even if politicians attempt to follow best-practice standards, local idiosyncrasies inevitably influence the outcome and produce hybrid economic forms (Boyer, 2001). National values, ingrained institutions, and centuries of tradition cannot as easily be swept aside as structuralists proclaim; the filters provided by domestic politics and institutions play a major role in determining what effect globalization has, and how countries are able to adapt to it (Gilpin, 2000).

While the structuralist-sceptics debate has largely defined the globalization debate, an alternative transformationalist perspective emerged in the late 1990s through the work of David Held and colleagues (Held et al., 1999), and was later elaborated upon by Colin Hay (2000; 2005) and Georg Sorensen (2004), among others. Key to this theoretical approach is a critical assessment of the assumptions that underpin the structuralist-sceptics debate. By highlighting the problematic nature of these assumptions, transformationalists attempt to develop a new theory that more accurately describes the changes taking place within the IPE. What these assumptions are and how transformationalists seek to overcome them is the subject of the next section.

Part 3: Transformationalism, a New Agenda?

Transformationalism emerged in an attempt to move beyond the lingering dichotomies, prevailing assumptions and empirical reductionism that characterized the structuralist-sceptics debate. Transformationalists adopted the structuralist sentiment that world politics were fundamentally changing, while also making use of the sceptics' empirically founded argument that the world was not fully integrated and that states still played a vital role in economic governance. Transformationalism is a highly diverse school of thought and is in danger of becoming an all-inclusive term. As Georg Sorensen comments, "Most scholars will probably say that they are transformationalist today, but the devil is in the detail" (2004, p. 191). The principal idea emerging from transformationalism is that the political vocabulary embedded in the structuralist-sceptics debate, structured by oppositions between state and civil society, public and private, government and market, coercion and consent, sovereignty and autonomy, insufficiently captures the diverse way in which rule is exercised in advanced liberal democracies in general (Rose & Miller, 2010), and

neoliberal economic restructuring processes in particular. This section will first discuss the key concepts of transformationalism and then develop a critical perspective on neoliberalism that coincides with, and strengthens, transformationalists' arguments.

Central to transformationalism is an attempt to move beyond the state/market dichotomy embedded in the structuralist-sceptic debate (Held et al., 1999). Both structuralists and sceptics see the state and the market as separate and antagonistic entities. The globalization debate is therefore largely predicated on an antagonism between global processes and the nation-state (Pozo-Martin, 2006). Transformationalists argue that such zero-sum logic between global economic forces and states should be abandoned; "metaphors of loss, diminution or erosion of state power misrepresent the nature and extent of state transformation taking place" (Held et al., 1999, p. 440). Rather than being eroded or constrained, the state is being transformed. Deregulation was never really deregulation; states did not decline, they adjusted. The reorientation of the state saw the replacement of outcome-orientated interventionism with a new form of pro-market re-regulation, which was, in many cases, more complex and onerous than the old type (Soederberg, Menz & Cerny, 2005).¹³

Geoffrey Underhill argues for the abandonment of the dichotomous state-market conceptualization and adoption of a state-market condominium that stresses the active role of the state in the production and maintenance of the global economic order (Underhill & Xiaoke, 2006). Drawing from Karl Polanyi, Underhill argues that the market has never emerged naturally or spontaneously, but rather, its development has required an active and expansive role of the state. As capitalism developed states became more involved in economic life than ever before, especially in the establishment and administration of the juridical, regulatory, and infrastructural framework in which private property and competition to operate (Panitch & Gindin, 2012). This is demonstrated, for example, by Levi-Faur's study of the electricity and telecommunications industries in 171 countries between 1980 and 2002. During this period the incidence of privatizations was exceeded by the creation of new regulatory authorities in these industries (Levi-Faur, in

¹³ Such regulation entailed a whole "new series of legalities including the production of new types of regulation, legislative items and court decisions necessary for securing the 'rights' of transnational capital" (Sassen, 2002, p. 94).

Cahill, 2011).

Transformationalists also criticize the characterization of the national and the global as antagonistic and mutually exclusive. Ian Clark describes this separation as the “Great Divide” in IR, or the “dichotomized state-versus-external-forces perspective” (1998, p. 418). The idea of globalization is a useful means to transcend this spatial reification; it denotes an increasingly complex and dense network of interactions occurring between global and local elements of human activity (Holton, 2005). Actors and processes involved in the global economy (such as CRAs) are increasingly prevalent in the domestic political environment, and *vice versa*. The divide between the external global economy and domestic politics is increasingly blurred. One sphere is not eroding the other.

Neoliberal globalization is neither an autonomous external force, nor simply a state-driven phenomenon (Clark, 1998). The state, as Clark argues, cannot be reduced to being an agent of national social forces, nor alternatively to the mere expression of international capital, rather it “operates between the two and is fully the prisoner of neither” (1998, p. 496). By abandoning the domestic/international divide the state can be seen as a middle ground between the internal and external: it is both shaped by and shapes the processes of globalization (Hobson & Ramesh, 2002). In order to adequately conceptualize the interactive nature of state-global interactions we must develop a more fluid, dynamic and interactive concept of state power (Clark, 1998). John Hobson has undertaken such a task:

The key to my theory of power is the notion that states are both domestic and international actors... [States reside] within an international/national vortex. Indeed, there are actually no such things as the international and national systems understood in pure terms. Although they can be separated for analytical purposes... they are embedded in each other. Neither is self-constituting, but each ‘dimension’ is constantly structured by interaction with the other. (1997, p. 11-12)

Ideas, for example, do not flow spontaneously. Rather, the travel of ideas is an active social process of translation: “Ideas are picked up, packaged and framed, projected and translated as they are embedded into new settings” (Djelic, 2008, p. 9). Carriers of ideas are active agents in this process of translation, reflecting in the process their own interests and purposes. The title of an article by Hobson and Ramesh (2002) attempts to capture this process: “Globalization Makes of States What States Make of It”. Indeed, the

continued salience of different national varieties of capitalism points to both the transfer to transnational norms and regulations and the particular histories and interests of individual states. An ongoing dialectic between global and national structures, interests, and norms, lies at the heart of contemporary capitalism.

States can channel international influences to bolster their domestic position and vice versa. Hobson and Ramesh seek to move behind the either/or binary that accompanies the traditional globalization debate and develop a both/and logic where the international realm is one of both possible opportunity and constraint. Colin Hay and Nicola Smith have pointed this out with regard to the Blair government's strategic use of no-alternative logic to justify the implementation of certain domestic policies. Globalization discourse, the authors argue, is used in highly strategic ways, the articulation of which depends greatly upon both the context and intended audience (2005, p. 124). Globalization is not just imposed from above, but is reshaped by and through local conditions and domestic political objectives. It is a political construction promoted by political entrepreneurs who must design projects, convince others, build coalitions and ultimately win some sort of political legitimacy for the neoliberal project from below (Soederberg et al., 2005). Globalization is, however, not only a transnational political project, but a non-deliberate movement—a dispersed mentality of governing.

The apparent misalignment between the state and global economy relies on a spatial fixing of power and influence of nation-states. Sovereignty today is much more complex; it is “less externally exclusive and internally hierarchical, and more shared, pooled and divided in different levels of governance and nodes of political activity and authority” (Soederberg et al., 2005, p. 4). Sovereignty has become alienable and divisible—states acquire new roles and powers as they cede others. International organizations (IOs) and private regimes do not represent a relinquishing of control, but are viewed as facilitators of strategic inter-state agreements. As Linda Weiss asks, why “should new forms of cooperation between states and other powerful actors – whether public or private, domestic or international – be, in principle, more restricting or less enabling than before?” (2003, p. 9). IOs, for example, represent enforcement mechanisms enabling governments to pursue their own interests and agreements through cooperation and compromise (Keohane, 1984).

Karl Marx stated that capital by its nature drives behind every border. However, a rarely quoted, but no less perceptive insight of Marx, was that while capital constantly overcomes “national barriers” so too are new ones “constantly created” (Panitch & Gindin, 2012, p. 2). Neoliberal globalization should not be considered the end of geography, but instead as a process entailing moments of both deterritorialization and reterritorialization. The emphasis on mobility of capital and the deterritorialization of economic transactions obscures the extent to which the apparatus of private governance of the global economy is “strongly territorialized or geographically embedded” (Hall & Biersteker, 2002, p. 12).

Territory, place and national governments still remain significant components of international politics. The discourse of globalization can often serve as an ideological construct used to justify and legitimize the expansion of Anglo-American-based capitalism (Held & McGrew, 2003). The prevailing idea that capital is footloose, that corporations are homeless and financial markets are ungovernable is misleading, and serves to discredit nationally based economic governance strategies by deeming them unfeasible. Globalization discourse represents the political construction of helplessness (Weiss, 1998). As Colin Hay remarks, “[We] should be wary of accepting uncritically, as many have, that globalization leaves states with no alternative other than to capitulate to the demands and desires of mobile investors...because to do so is effectively to deny the possibility of the democratic governance of economic processes in contemporary societies, certainly at the national level” (2007, p. 315). We cannot confuse discourses of private power with the erosion of the state. Constructing the appearance of helplessness and ineptitude in the face of global economic forces can insulate governments from domestic accountability and render opaque the responsibility for the crisis-tendencies embedded in neoliberal forms of accumulation.

The causal significance of ideas is central to this perspective and is a reaction against the materialist bias – that is, the focus on the determinative role of certain economic laws – embedded in the structuralist-sceptics debate (Berry, 2008; Hay & Marsh, 2000). There is a deadlock between structuralists who argue that a fully integrated global economy exists, and sceptics who argue it does not. Transformationalists, however, pose the question: does it matter? While we may be able to deny the globalization of politics (i.e.,

levels of economic integration) we cannot deny the politics of globalization: that is, the perception that the world is increasingly globalized (Hay, 2007). By describing states as being embedded within a global economic system that imposes certain material constraints on state policy, structuralists inadvertently reinscribe the very configurations of power they seek to contest: namely globalization's inevitability (Gibson-Graham, 1996). Globalization should be understood as an economic discourse:

Policy-makers, CEOs, NGOs, anti-capitalist protesters and new social movements do not react to 'globalization' as such. Rather, they react at best to a mediating discourse which tells them what globalization is, how it affects their lives and, most crucially, how it will affect them in the future. The aggregate reaction and response to the mediating discourse, in turn, is an important component shaping the 'reality' of globalization itself. (Cameron & Palan, 2003, p. 3)

The fact that states are key decision-makers in world affairs does not refute the rise of private authority in that arena. States are not "atomistic egoists, whose interests are formed prior to social interaction, and who enter social relations solely for strategic purposes" (Reus-Smit, 2009, p. 217). Rather certain actors can, in the Foucauldian sense, influence policy outcomes through the productive generation of identities or intersubjective meaning. The new international environment has witnessed a relative decline in command-based and hierarchical mechanisms of control and shifted towards ideological convergence or intersubjective consensus as a significant mechanism of governance (Rosenau & Czempiel, 1992). Once the power-relations embedded in intersubjective meaning are brought to light, the study of the political process turns into a question of who learns what, when, to whose benefit, and why. By conceiving the generation of consent as an element of power, the nexus between power and knowledge is highlighted.

Saskia Sassen describes a new type of authority emerging; a state practice that entails a partial denationalizing of what has been "constructed historically as national" (2003, p. 242). States are endogenizing global and private agendas into the public realm of the state. What was previously external is now being internalized into the way states operate. This process differs from traditional analysis of private authority in that it seeks to detect the presence of private agendas and authority inside the public arena of the state. This renders irrelevant the traditional public/private distinction as it creates a "hybrid" form of power that is neither fully private nor public. The public/private distinction is problematic as it neglects the

possible emergence of authoritative private actors and their interests emerging inside the policy process (Hall & Biersteker, 2002). This also applies for state interests emerging inside, or being forwarded by, private actors. As the New Zealand case will demonstrate, the National government was able to embed its own domestic political interests inside private actor recommendations by selectively interpreting their meaning.

Despite making considerable progress in moving beyond the assumptions embedded within the structuralist-sceptics debate, a developed theoretical elaboration of neoliberalism and its relation to globalization and state transformation is absent from transformationalist scholarship. While transformationalists question the state/market dichotomy and argue that the state still plays a role in economic governance, what form the state takes, how it governs, and how we are to reconcile active state involvement in the economy with prevailing conceptions of neoliberalism are left unanswered. By exploring some recent contributions to the critical literature on neoliberalism, particularly that by economic geographers such as Jamie Peck (2008; 2011), Adam Tickell (2002) and David Harvey (2005), the following section seeks to answer some of these unresolved questions.

Neoliberalism and Transformationalism

Some recent contributions to the critical literature on neoliberalism are useful to further develop the theoretical insights of transformationalism. There is a tendency for neoliberalism to be treated as self-evident, essentialised, or black-boxed. This section will provide a working definition of neoliberalism that will be referred to throughout the thesis. While the state actively contributes to the making of global capitalism, how it is able to do this, and what form it takes, requires theoretical elaboration. By exploring the social and economic aspects of neoliberal governance, the aim is to provide theoretical insight into how the state governs in a period of neoliberal globalization. Developing a theoretical understanding of state-based governance strategies is useful for later chapters that seek to understand how the New Zealand government is able to co-opt the expertise of private actors.

The origins of neoliberalism can be argued to lie in the 1930s in the Mont Pelerin Society (MPS) (Mirowski & Plehwe, 2009). At the time, however, the neoliberal project was consistently rejected by

governments in favour of Keynesian economics and the embedded liberal compromise that characterized the post-war period. In its earlier project form, neoliberalism can be viewed as a set of counter-hegemonic political and intellectual struggles, emerging in opposition to the rise of Soviet communism in the East, the welfare state in the West, and widespread acceptance of Keynesian-style approaches to macroeconomic management (Mudge, 2008). Neoliberalism did not come to fruition until the 1970s. Here it gained momentum in response to a range of crisis tendencies inherited from the post-war economic order, the blame for which was unambiguously placed at the door of Keynesian economics, financial regulation and state ownership (Brenner, Peck & Theodore, 2010). Throughout the 1970s and 1980s neoliberalism began its journey from a marginalized set of intellectual convictions to a hegemonic force in world politics.

The use of the term “neoliberalism” in the social sciences has been accompanied by considerable imprecision, confusion and controversy (Brenner et al., 2010). Both structuralists and sceptics have equated neoliberalism with a simple and fixed set of economic policy prescriptions,¹⁴ but this misconstrues significant components of the neoliberal project. Neoliberalism is not a simple and homogeneous philosophy (Thorsen & Lie, 2006) – and never has been (Mirowski & Plehwe, 2009). Neoliberalism should be conceived as a *restructuring ethos*, a hegemonic pattern of incomplete and contradictory regulatory transformation (Brenner et al., 2010). Recognizing the contradictory nature of the neoliberal project helps explain why, as Held and McGrew argue, economic globalization “harbours no fixed or given pattern of historical development...it pulls and pushes societies in different directions, it simultaneously engenders...convergence and divergence” (2003, p. 7).

Nothing in the neoliberal doctrine restricts neoliberalism to a fixed set of ideological prescriptions. As Hayek himself reflects, “nothing has done as much to harm the liberal cause as the wooden insistence on certain rules of thumb, above all the principle of laissez-faire” (in Peck, 2008, p. 5). Neoliberalism was from

¹⁴ This occurs largely because of neoliberalism’s historical association with the Washington Consensus. The Washington Consensus originally developed as a set of policy prescriptions for Latin America and became synonymous with market fundamentalism and Structural Adjustment Policies (SAPs). Throughout the 1970s and 1980s, the IMF attached various conditions on loans given to developing nations; these nations were required to implement what was called structural adjustment policies, involving privatization, deregulation, and a range of measures aimed at fiscal austerity. The fixed nature of these policies and their association with neoliberalism has created the problematic impression that neoliberalism is also a fixed project.

its very beginnings a polycentric and plural project. While unified in opposition to socialism, the members of the MPS were very much divided over the core principles of the neoliberal project, specifically the role of the state (Peck, 2008).¹⁵ The founding declaration of the society explicitly refused to commit to any meticulous or hampering ideology. The ideational project of neoliberalism was formed as a flexible and open-ended one; “there was never a singular worldview, nor was there an expectation that one would be developed” (Peck, 2008, p. 26). As neoliberalism is a dynamic and flexible project, the landscape of existing neoliberalism(s) is not a space of convergence. Neoliberalism is a variegated form of regulatory restructuring, which produces geo-institutional differentiation across places, territories, and scales as one of its “essential, enduring features” (Brenner et al., 2010, p. 330).

Uniform conceptions of neoliberalism result from a tendency to equate neoliberalism with neo-classical economic theory, or as a reinstatement of 19th century laissez-faire. As Mirowski and Plehwe argue, it would be a fallacy “to regard neoliberalism as falling narrowly within the purview of the history of economics” (2009, p. 427). This becomes more apparent as the historical record illustrates that the neoliberals themselves regarded such exclusivity as a prescription for disaster (Mirowski & Plehwe, 2009). Neoliberals prescribe the expansion of the economic domain into both the social and the political spheres; the economic sphere does not represent some firmly demarcated area of activity, rather neoliberalism is a philosophy of government that “essentially includes all forms of human action and behaviour” (Lemke, 2001, p. 198). The distinction between the social, political and economic spheres collapses as policy becomes dictated by the criteria of economic efficiency. Recognizing the all-encompassing dictates of neoliberalism expands the necessary methodological scope for transformationalists, who now must explore interpenetration of the social, economic and political spheres, if they wish to adequately access the processes of neoliberal globalization.

Just as Polanyi observed in the rise of 19th century liberalism, neoliberals recognize that the market, and the conditions necessary for its existence, do not emerge naturally or spontaneously but must be

¹⁵ Despite agreement regarding a necessary role for the state in the economy, neoliberalism has consistently struggled with the question of how to define and delimit the appropriate role of the state (Peck, 2008). Both Ordo-liberalism (the Austrian variant of neoliberalism) and the Chicago school can be defined as neoliberal; the two, however, contain differing perspectives on the appropriate role of the state.

created by the state. As former MPS president James Buchanan argues, “Of necessity, we must look at our relations with the state...to use the familiar Nietzschean metaphor...Man is, and must remain, a slave to the state” (in Mirowski & Plehwe, 2009, p. 5). Hayek continues:

It is important not to confuse opposition to...planning with a dogmatic *laissez-faire* attitude. The liberal argument does not advocate leaving things just as they are; it favours making the best possible use of the forces of competition as a means of coordinating human efforts. It is based on the conviction that, where effective competition can be created, it is a better way of guiding individual efforts than any other. It emphasizes that in order to make competition work beneficially a carefully thought-out legal framework is required... [However, there is no] ‘middle way’ between competition and central direction...Planning and competition can be combined only by planning *for* competition, not by planning *against* competition. (Hayek, in Peck, 2008, pp. 11-12)

The market, as transformationalists recognize, can exist only under certain political, legal and institutional conditions that must be actively constructed by the state. The primary ambition of the neoliberal project is thus to redefine the shape and function of the state, not to destroy it (Mirowski & Plehwe, 2009). Despite the enduring rhetorical trope of the night-watchman state, neoliberalism had from the start a distinctly positive conception of the state as the guarantor of a competitive order (Peck, 2008). The processes of marketization and commodification are always mediated through state institutions. Not only are certain institutional foundations required, but, contrary to the classical liberal’s view, the human tendency to barter, truck and trade must also be artificially created.¹⁶ The human inclination towards competitiveness, the so-called entrepreneurial subject, must be actively constructed. Neoliberalism, as Lemke argues, “no longer locates the rational principle for regulating and limiting the action of government in a natural freedom that we should all respect, but instead posits an artificially arranged liberty” (2001, p. 10).

What does this state look like? And how does it govern? These are questions to which transformationalists have paid insufficient attention. As a regulatory experiment neoliberalism generally entails both a destructive moment, defined by efforts to rollback market-restricting state apparatuses, and a

¹⁶ *Homo economicus* does not constitute a pre-given human nature, as in liberalism, but is an “artificially created” form of behavior (Lemke, 2001). Neoliberalism is thus constructivist by nature.

creative moment, including strategies to roll forward a new socio-political infrastructure through regulatory reforms (Brenner et al., 2010).

Rollback neoliberalism is characterized by state withdrawal from the economy and often generates counter-hegemonic social forces. The social hardship and political unrest generated from fiscal austerity was illustrated in the slums of Nicaragua in the 1970s and Athens in 2012. Neoliberal processes of regulatory restructuring frequently undermine the very conditions necessary for their existence; policy failures and internal contradictions are in fact central to the neoliberal project as they provide further impetus for the acceleration, proliferation and diversification of neoliberal forms across different sites and scales (Brenner et al., 2010). The crisis-tendencies provoked by the initial dismantling of the state during the 1980s and 1990s have triggered an emergent phase of active state-building and re-regulation, termed roll-out neoliberalism. Here the focus on the neoliberal project shifts from discrediting Keynesianism and social-collectivist institutions to one defined by the purposeful construction and consolidation of neoliberal state forms and modes of governance (Peck & Tickell, 2002).

Roll-out neoliberalism can be described as an emerging regime of techno-managerial governance designed to limit unwanted political interference in economic decision-making processes. While the primary mechanisms of neoliberalism may have been economic in nature, neoliberalism was essentially a political response to the democratic gains that had been achieved by the working class, which from capitalisms perspective, became barriers to neoliberal forms of accumulation (Panitch & Gindin, 2012). Aaron Major (2012) describes this process as “reregulation as depoliticization”: the movement of regulatory activities into “technocratic, insular institutions dominated by public officials and private institutions” (2012, p. 538). Stephen Gill’s (2008) concept of new constitutionalism is also useful; it describes the process in which neoliberal reforms are institutionalized via the quasi-legal restructuring of the state. Economic policies are deemed technical in order to erect a barrier between the economic and the political, and thus limit unwanted political interference (Gill, 2008, pp. 138-139).

Such arguments are not limited to the critics of neoliberalism. As James Buchanan argues, there

must be “explicit constitutional limits on the intrusion of politics into the market...[this has the] advantage of providing stability of expectations for persons and groups, internal and external, who might make long-term investments” (in Gill, 2002, p. 57). Neoliberal globalization therefore relies upon, and indeed produces, “the exclusion of dissident social forces from the arena of state policy making in order to insulate the neoliberal state form from societal contestation” (Ammore et al., 1997, p. 181).

The social component of roll-out neoliberalism entails the production of self-regulating subjects. Due to the hegemonic logic of neoliberalism in the 21st century, freedom is commonly conceived as the antithesis of government and/or power. Neoliberalism is thus conceived of as an “act of liberation” from the power of the state, which grants the power to do as one likes (Rose, 1999). Subjects, however, are not simply freed from the constraints of governmental power, but as Foucault (2011) points out, they must be made capable of being free subjects. The new tasks and functions of the neoliberal state entail a variety of interventions in which certain values, attitudes and dispositions are inculcated so as to encourage individual responsabilization and competitiveness (Rose, 1999). The creation of these self-regulating subjects depends on various technologies of government, mechanisms through which authorities seek to “shape, normalize and instrumentalize the conduct, thought, decisions and aspirations of others in order to achieve the objectives they consider desirable” (Fougner, 2008, p. 307).¹⁷ The result is the creation of seemingly free subjects, who are nonetheless governed by their own drive toward self-regulation and material gain.

States’ promotion of financial literacy, for example, can be seen as an effort to internalize a neoliberal mentality among citizens (Arthur, 2012). Responsibility for individual financial well-being is shifted away from the state or collective and towards the individual him- or herself. The mobilization of public resources via collective action is discouraged. Conversely, financial investment, once characterized as gambling and foolish speculation, is described as a legitimate means of self-improvement and, most importantly, a method by which one can secure his or her security (Allon, 2010).

¹⁷ Competitiveness indexing, for example, is not simply disciplining state action; rather, it is actively producing states and state behavior by providing seemingly neutral and “rational” policy recommendations that states actively internalize and in turn act upon. Thus benchmarking practices do not coerce states to improve their performance. Rather, operating largely “at a distance”, they seek to harness the capacity of states to govern themselves in a rational and calculated fashion (Fougner, 2008).

As this section has illustrated, in line with transformationalism, neoliberalism by definition adopts a positive conception of the state: a neoliberal *restructuring ethos* promotes active state involvement by planning for competition in economic, social and political realms of human activity. This ethos is by no means uniform, but is a polycentric, heterogeneous and evolving project. This explains why transformationalists describe economic globalization as lacking a linear historical trajectory and as generating both convergence and divergence. More importantly, the notion of roll-out neoliberalism fleshes out the transformationalists' observation of an active state. The depoliticisation described above is played out in the New Zealand case study, as the National government sought to use credit ratings to limit political interference by generating the perception that certain policies were technical, while the disciplinary effectiveness of credit ratings depends on the willingness of states or, as in this case, citizens, to be properly self-regulating subjects.

Conclusion

This chapter has discussed the impact of neoliberal globalization on the decision-making autonomy of states. It has discussed the structuralist-sceptics debate with an emphasis on the theoretical assumptions upon which it is built. Next, transformationalism was put forward as an alternative theoretical framework from which to view power in the international political economy and the role of the state in the contemporary global economy. This perspective attempted to move behind the rigid confines and dualistic accounts embedded in the structuralist-sceptics debate, most specifically the false dichotomies between market/state, global/national and the public/private. In order to develop a more theoretically detailed account of transformationalism, particularly that related to the role, form, and function of the state, a detailed account of neoliberalism, and neoliberal state transformation, was put forward. As noted in the introduction, the current literature on CRAs' power is firmly located within the theoretical confines set by the structuralist-sceptics debate. By developing a transformationalist theoretical approach this chapter sought to provide an alternative theoretical framework from which to view the power of CRAs. Using this framework, the next chapter will critically access the prevailing economistic rationale given for the emergence of CRAs.

Chapter 3: The Transformation of Global Finance

Introduction

In market economies, financial markets serve to allocate the supply of credit. They thereby determine who has access to credit and at what costs. The primary economic and social function of a financial system is therefore to establish relationships between savers and borrowers; the idea is to bring their situations into harmony, while making optimum use of available monetary resources (Dembinski 2009, p. 84). Financial markets, however, are not historically stagnant, but are subject to forces of change. Recent systemic changes in global financial markets have, indeed, provided an impetus for the development of the credit rating industry and the consolidation of CRAs' influence in global financial markets. These changes are often termed financial globalization—whose *raison d'être* is the free and unhindered movement of capital (Abdelal, 2007). The structural coherence granted to this term, however, insufficiently captures the multifaceted changes that are taking place in the world of finance. This chapter will discuss the causes and nature of these change taking place as well as the outcomes they are producing, in terms of both CRAs and global finance more broadly.

The chapter will also draw attention to the inability of neo-classical economic theories to explain the power of CRAs. From their perspective, CRAs have market legitimacy as an outcome of their contribution to market efficiency. Their authority is thus the result of the particular function they perform in solving existing information asymmetries in capital markets and providing market participants with needed information on the risk of various financial products. Rather than focusing exclusively on markets, and in line with transformationalism, this chapter looks to explain the power of CRAs by attending to the interpenetration of the social, economic and political spheres, which are always bound together, influencing one another, yet not simply reducible to one another.

Part 1: The Resurrection of Global Finance

Capital flows grew rapidly in size and velocity during the era of the classical gold standard (1878-1914), but the First World War along with the Great Depression of the 1930s resulted in a number of countries pursuing protectionist economic policies that severely hindered the free movement of capital. One country after another adopted a series of measures designed to protect their national economies; through exchange controls, currency devaluations, and import restrictions, these measures brought capitalism's tendencies towards globalization to a standstill. By 1932 world trade had effectively fallen to one-third of its 1929 levels, and both short and long-term international credit had dried up (Panitch & Gindin, 2012). Coincidentally, throughout the 1940s and 1950s a widespread belief existed among both policy makers and the public regarding the inherently destabilizing and volatile nature of footloose capital (Erturk, 2008). This sentiment was captured in the policies of Franklin Roosevelt's New Deal, as he stated in his inaugural address in 1933: "The practices of unscrupulous money changers stand indicted in the court of public opinion" (in Panitch & Gindin, 2012, p. 54). Because speculative capital flight was seen as a driving force behind the financial collapse, the next attempt to set up an international monetary order at Bretton Woods in 1944 placed considerable constraints on capital movements (Helleiner, 1999).

The prevailing orthodoxy throughout the 1930s to the 1970s was that capital should remain the servant of the state. The post-war economic order hinged on the expectation that the state would intervene in society to alleviate the potentially deleterious effects of the global economy, and that it would restrict financial market activity only to that which benefited the domestic economy in terms of securing full employment and promoting productive enterprise (Ruggie, 1982). These policies coincided with the potentially contradictory goal of promoting an international regime of free trade. This was termed the embedded liberal compromise. Despite the liberalization of international trade, the Bretton Woods system (BWS) created a multilateral regime in which capital would remain firmly rooted within national borders and subject to state controls: economic liberalization was therefore partial and incomplete.¹⁸ Capital controls,

¹⁸ Harry White and John Maynard Keynes believed that the liberalization of trade and the liberalization of financial markets were fundamentally contradictory policies; while trade should be liberalized, finance must remain a "servant" to the state (Helleiner, 1996).

along with already low levels of cross-border financial flows, gave national authorities considerable policy autonomy over financial markets during this period (Held et al., 1999). As a result of these developments, the credit rating business, which once flourished in the booming economy of the 1920s, began to steadily decline.

The prevailing Keynesian orthodoxy promoted production and investment rather than speculation and consumption. As a result, the speculative bond market that thrived in the 1920s began to dry up. The limited amount of private capital flows throughout this period, along with the supervisory role played by the newly created World Bank and IMF, and the liquidity provided by the Marshall Plan, created a situation of relative financial and economic stability from 1944 to the early 1970s (Gaillard, 2011). The stability in the sovereign debt market led investors to believe that the risk of sovereign default had subsided, and, therefore, so too did the number of countries that required sovereign credit ratings (Langhor & Langhor, 2008). As Richard Sylla describes it, the US bond market was “too safe” for rating agencies “to matter much” (2002, p. 21). In 1929 the leading four CRAs rated 120 sovereign bonds, but by 1968 S&P had suspended its sovereign rating activity, and only rated Canada and the United States (Gaillard, 2011, p. 7).

One consequence of the interventionist role states began to play in domestic economy was the implementation of the Interest Equalization Tax in 1963 in the United States. This tax, designed to limit the outflow of US capital, considerably restricted the amount of foreign debt able to be issued in the US (Gaillard, 2011, p. 6-7). This severely restricted any global business the rating agencies might have obtained as foreign corporate debt was largely excluded from US securities markets (Sinclair, 2001). As a result of foreign capital drying up in the US, term loans issued by banks became the primary means of financing. Banks therefore became the dominant financial intermediaries, which further marginalized the credit rating business.

The initial cracks within the BWS were driven by the emergence of offshore financial space in the 1960s (Held et al., 1999, p. 201).¹⁹ At the time, managers, investors, and speculators began to creatively find

¹⁹ Offshore financial space is, as Langley describes it, “credit creating practices which take place beyond the reach of

new ways around national regulations on capital movements. The Euromarkets, based primarily in London throughout the 1960s, were the most significant markets in this respect,²⁰ within which market transactions could be made in non-local currencies and traded independently of national regulations, thus making such trading significantly more profitable (Abdelal, 2007). In a world of widespread capital controls, the Euromarkets represented a location where international financial operations could be conducted relatively freely (Helleiner, 1996, p. 320).

Despite claims to the contrary, the Euromarkets were not stateless markets – they did not emerge simply as a result of private actors pursuing their interests; rather, both the US and British governments played an instrumental role in their creation and consolidation (Helleiner, 1996). The British government, acting on a nostalgic longing to reclaim its historic financial centrality, refrained from imposing controls on Euromarket activity, and, in fact, actively encouraged its development through various regulatory and tax changes. US support was equally important given the dominant role played by American banks and corporations in the market. Rather than preventing such corporate activity, the US government actively encouraged US banks and corporations to shift their operations to the offshore market in order to increase their global competitiveness (Helleiner, 1996, pp. 320-321).

Following the unbridled success of the Euromarkets, the United States and Great Britain began deregulating their own financial centres throughout the 1970s. This initial drive toward liberalization set off a wave of competitive deregulation as foreign countries attempted to slow capital flight by deregulating their own financial markets (Helleiner, 1996). National finance industries were obliged to follow this path or suffer declines in their own finance sectors as funds relocated to more open markets (Sinclair, 1999). This was not simply a race to deregulate, however; as Langley points out, “deregulatory pressures have been cross-cut by similar competitive demands for new market-orientated regulations” (2003, p. 113). The widespread adoption of the Basel Capital Adequacy Standards illustrates just such a dynamic occurrence.

the regulations which apply in the ‘home’ national political economy of the currency in which the credit created is denominated” (2003, p. 76).

²⁰ Here the Euromarket is used to describe a specific period in the development of offshore finance. Within the Euromarket, distinctions are made between ‘Eurocurrency markets’ (offshore money-markets), ‘Eurobonds’ (offshore bond issues and trades) and ‘Eurocredits’ (offshore bank lending) (Langley, 2003, p. 76).

The liberalization of financial markets witnessed a dramatic increase in the volume of private international capital flows. This produced an inherent tension within the international monetary system described as the unholy trinity: the intrinsic incompatibility of exchange rate stability, capital mobility, and national policy autonomy. This tension came to a head in 1971 when President Nixon, facing a rapidly growing balance-of-payment deficit and growing speculation against the US dollar, announced that the US dollar would no longer be directly convertible to gold. Following the US, other major currencies went off the gold standard; by 1973 all of the world's major currencies were allowed to float and became freely tradable. With the restoration of current account convertibility, capital controls became more difficult to enforce as it became easier to under- and over-invoice trade, and thus shift funds abroad (Eichengreen, 2008). Also, the development of the Euromarket, in which London-based banks began to accept and trade US dollars, reduced the ability of American regulators to control capital movements at the border as a pool of dollars already existed offshore (Eichengreen, 2008, pp. 119-120). This increasing difficulty, combined with the ideological shift towards neoliberalism that occurred in the 1970s and 1980s, meant capital controls were largely abandoned and capital would once again become mobile. The rise of transnational capital flows introduced an inherent element of systemic instability into the global financial system, thereby increasing the need for arbiters of financial risk assessment.

The two oil price shocks of 1973 and 1976 destroyed any remaining hope of restoring the BWS. The crises produced large payment imbalances between OPEC countries and industrialized nations. It subjected the world economy to massive inflationary pressures that led budget deficits to rise to unprecedented levels. As a result, by the 1970s monetarism was on the rise in most developed countries. Rather than overt monetization (i.e., printing money) to finance rising budget deficits, developed countries sought to tap into international capital markets by issuing government bonds. Within this period international bond financing grew dramatically as governments sought to finance their current account deficits along the lines of new anti-inflationary orthodoxy—debt creation (Dembinski, 2009). The international finance industry was the chief beneficiary of these developments (Reinicke, 1995).

The most significant outcome of this process is the increasing role of private actors in the allocation

of capital in the global economy. By allowing large-scale lending and borrowing to occur in the absence of state regulations, the Euromarket created a massive source of private liquidity unable to be directly controlled by central bankers. Concurrently, the monetarist turn in economic orthodoxy triggered the demise of direct state intervention in economic affairs and the rise of market-based mechanisms of governance. As borrowing from private capital markets grew rapidly, private institutional investors became central players in global economic affairs. There is no reason, however, why the rise of new actors, private or otherwise, should be seen as more or less enabling for state sovereignty. The emergence of the Euromarket was not a private victory over state actors, but the result of a state-market confluence of interest. Contrary to mainstream economic accounts, financial globalization should not be conceived of as a logical consequence of market forces.

While financial globalization has, broadly speaking, heightened the need for certain institutions of credit evaluation, why CRAs in particular have emerged to fill this void remains unanswered. Why have banks not re-emerged to fill the role that they once played as financial intermediaries? The next section will answer these questions by exploring the emergence of a qualitatively new financial architecture.

Part 2: Financialization and the New Politics of Credit

The liberalization and deregulation of domestic financial markets have produced a radical restructuring of the financial and banking industries (Rethel & Sinclair, 2012). These changes, captured under the rubric of *financialization*, have produced a growing demand for CRAs as informational intermediaries in global financial markets. Financialization is a neologism attempting to capture the increasing role of finance, financial actors, and financial motives, in contemporary market economies (French, Leyshon & Wainwright, 2011). This historical transformation has been described as a response to the crisis of profitability that characterized the late Fordist period of mass industrial development and driven largely by an intensification of worldwide competitive pressures. To compensate for the stagnation of economic growth and declining income from trade exports, the US increasingly turned to its leading position in global finance as a source of revenue (Panitch & Gindin, 2012). For a number of different reasons this model was exported to the rest of the world, albeit in a heterogeneous manner. With regard to the

central aspect and outcomes of financialization, significant academic divergence persists.²¹ Table 2

highlights four changes that have occurred within financial markets as the result of financialization and each, to varying degrees, helps to explain the rise to prominence of CRAs in contemporary market economies.

Table 2: Aspects of Financialization

Sphere of Inquiry	Focus	Evidence
Economic governance	How the governance of firms is impacted by the increasing participation of shareholders in corporate governance.	An emerging regime of corporate governance directed by large institutional investors aimed toward the maximization of shareholder value (short-termism) as the primary objective of management. ²²
Quantitative changes in financial markets	Shifts in profit portfolios of financial and non-financial corporations.	The rise in the profits of the financial sector relative to the non-financial sectors, and an increase in the percentage of profits that non-financial firms accrue from financial transactions.
Qualitative changes in the make-up of financial markets	Declining role of banks as financial intermediaries and the increasing complexity of financial products.	The disestablishment of traditional banking intermediation, and the proliferation of new financial products resulting from a shift toward an originate-to-distribute model of banking.
Socio-cultural changes	Shift in socio-cultural narratives surrounding savings and investment.	The increasing participation of individuals in financial markets driven by an emerging investment culture. Most prominently seen in the increasing participation in, and size of, pension funds, mutual funds, and day-trading activities.

Driven largely by the integration of previously segmented financial centres, quantitative changes in financial markets draw attention to the rising significance of financial markets as a means of wealth creation, distribution, and management. Econometric data on the profits of US firms, both financial and non-financial, underscore the increasing number of actors and amount of wealth participating in the financial sector. The growth of the financial sector's profits in America relative to other non-financial industries has been considerably large: the financial sector's total share of profits rose from 10% in the early 1980s to 40% in 2007 (Krippner, 2005).

Similar trends have been experienced globally, albeit at the slower rate. In 1983 foreign exchange

²¹ Gerald Epstein, purposefully constructing a broad definition, defines financialization as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies" (2005, p. 3). For Erturk and colleagues, financialization denotes "the growing influence of capital markets (their products, actors and process) on firm and household behaviour" (Froud, Johal, Leaver & Williams, 2008, p. 556).

²² David Hudson describes this process as, "the imposition of short-termist restructuring rather than decisions based on longer term production enterprise" (2005, p. 64). The decision-making capacity of firms is increasingly constrained by the demands of shareholders.

transactions were ten times as large as world trade; by 1999, even though world trade experienced rapid growth over the period, foreign exchange transactions rose to seventy times the value of world trade (Sassen, 2005). As a result of the rapid growth of global financial markets and the accompanying proliferation of financial products, there has been an increase in demand for credit rating agencies' judgements. Credit ratings provide comparable information on the credit risk of a large number of financial products, actors and institutions to an increasing number of people participating in financial markets.

Financialization not only describes an increase in the volume of global financial flows, but also a transformation in the make-up and governance of financial markets. The emerging regime of shareholder governance brings attention to the increasingly prominent role of shareholders in financial markets and their impact on corporate governance. As the investment decisions of large institutional investors, who generally manage individuals' investments,²³ can impact on the borrowing costs of companies and governments, those entities seeking funds are forced to adopt the policy preferences of investors.²⁴ Due to a lack of perfect information and market uncertainty, such investors often rely on third parties to provide reliable information on investment risk. Thus, as private institutional investors gain influence, so too do the institutions, like CRAs, which help guide their investment judgements by providing reliable information on creditworthiness.

While such observations are useful, they are limited in their ability to explain why more actors are participating in financial markets, and why banks have not reclaimed their position as financial intermediaries. A more fruitful discussion relates to the qualitative changes in financial markets that are centred on the trends of disintermediation and securitization. These processes are central to the growing importance of CRAs and to understanding financial markets in general. They, however, remain largely unexplored within both IPE and comparative political economic literature (Konings, 2007).

²³ While an increasing number of individuals are participating in financial markets, they are doing this in a largely indirect fashion, that is, through an institutional investor that manages their money. As of 2005, just before the financial crisis, around 70 percent of all global financial assets were administered by institutional investors (Kruck, 2011).

²⁴ This has been associated with the rise of short-termism in management policies. It is most vividly seen in the current preference given to mergers and acquisitions (M&A), which do not necessarily increase the productive capacity of firms but can nonetheless cause short-term increases in share prices.

Disintermediation

Banks were traditionally the central entity through which funds were borrowed and lent; they acted as financial intermediaries bringing together the supplies and users of funds (Sinclair, 2005, pp. 154-155). This is described as a *bank-based economy*, in which banks are the primary actors making decisions concerning the allocation of capital in the global economy. As Dembinski points out, in bank-based economies “most financial functions are performed by banks, which are therefore partners in all financial relationships and most transactions...they collect excess liquidity and savings, grant loans to governments and enterprises and redistribute parts of the income to savers” (2009, pp. 84-85).

The traditional theory of financial intermediation describes the rationale of bank intermediation as reducing information asymmetries, lowering participation costs and providing the quasi-public function of risk management (Erturk & Solari, 2007; King & Sinclair, 2003). By absorbing excess liquidity during times of growth, banks were able to use up reserves when returns were low and provide an anti-cyclical buffer.²⁵ Furthermore, as banks’ profits were driven by the interest accumulated while bringing loans to maturity, along with being subject to losses incurred in cases of default, they were obliged to prudently assess the creditworthiness of borrowers. This vastly reduced the number of risky debtors obtaining credit and thereby lowered the overall levels of risk in the financial system. Finally, because banks were subject to financial regulations that restricted their ability to leverage debt and take on risk, investors could depend on the relatively low-risk behavior of banks and the safety of deposited funds. Banks thus occupied a hybrid position between the public and private sectors, as Taylor and Singleton comment:

Contrary to the image of a dichotomy between state and market exchange, banks represented a fusion of these roles. They have operated as hybrid institutions of collective action, between state and market, that acted to control risks and reduce the uncertainties for the political authorities, as well as for borrowers and lenders. (in Sinclair, 1994, p. 450)

As an outcome of financialization, this role played by banks has been increasingly eroded. Changing patterns of investment and borrowing have radically altered the traditional bank-based economy. These

²⁵ This process is known as inter-temporal smoothing (Allen & Santomero, 2001).

changes – termed disintermediation – have diminished the traditional, quasi-public, role of banks as financial intermediaries and have created a “qualitatively new and unique institutional basis for financial intermediation” (Konings, 2007, p. 47). Sinclair describes these changes as “the movement from an institutionalised world of legal authorities towards a decentralized, marketized world of credit” (1999, p. 166). As will be discussed, the transition of banks away from their traditional tasks of anti-cyclical buffer, prudent assessor of creditworthiness, and low-risk behaviour, has introduced an element of volatility and unpredictability into the global financial system to which CRAs have responded.

Disintermediation denotes a situation in which borrowers and investors meet directly in capital markets as opposed to such transactions being intermediated by banks. It therefore occurs in two distinct forms—that is, changes in investing and borrowing practices. First, investors have increasingly come to avoid the use of established intermediaries and invest directly in capital markets. Depositors, particularly in the Anglo-Saxon world, are increasingly shifting away from banks and toward alternative and seemingly more attractive and lucrative forms of investment. This includes portfolio investment, mutual funds, pension funds and hedge funds. Fifty-one percent of US households owned a portion of the stock market in 2001, which was up from 25% in 1985, and 3% in 1929 (Langley, 2007).

This transformation was not solely the result of elite-led financial liberalization. Rather, it was also driven, in part, by a shift in the socio-cultural foundations of markets, specifically a transformation in what was deemed *appropriate* financial conduct. Whether or not the elite encouraged the formation of such social discourses is a different matter. Theories of elite-driven financialization, along with neo-classical economics’ exclusive focus on market dynamics, become problematic as they disavow the *everyday life of global finance*—the ways in which aspects of normal daily life contribute to processes of change and power in the global economy (Langley, 2008; Hobson & Seabrooke, 2007). In this process the once separate spheres of high finance and low finance become intricately intertwined.²⁶ As Langley argues, “The category of everyday life does not just provoke a concern with that which is neglected in the vast majority of

²⁶Adam Harmes, for instance, discusses “the emergence of a widespread ‘investment culture’ which has played a critical role in strengthening the hegemonic dominance of finance capital linking the perceived interests of tens of millions of workers to its own by embedding ‘investor practices’ in their every-day lives” (in Langley, 2007, p. 71).

accounts of contemporary finance, that is with the mundane routines of saving and borrowing. It also directs us to view transformations in those routines as crucial to the constitution and contestation of contemporary finance” (2008, pp. viii-ix).

There has been a transformation of prevailing cultural narratives away from prudential saving towards a culture of mass investment. Financial investment, once characterized as gambling and foolish speculation (de Goede, 2005), is now seen as a legitimate means of self-improvement and a method by which an individual can secure their financial autonomy. Fiona Allon captures this shift: “Practices of investment and speculation and their embrace by ordinary individuals is [now] taken as a sign of personal initiative, self-management, and enterprise rather than moral or budgetary imprudence” (2010, p. 367). The shifting investment practices of households supply large amounts of liquid capital into private equity markets. This comes to form the material basis for disintermediated credit practices, which now dwarfs the volume of intermediated credit (Erturk, 2008).

As more actors bypass banks and invest directly in financial markets, the need for reliable and simplified information on credit risk is heightened. CRAs meet this demand by providing simplified depictions of relative default risk in the form of a credit rating. As Abdelal notes, “The decision, increasingly widespread, of holders of capital to bypass the bank and invest directly in securities implied that a new premium would be placed on the accumulation and simplification of information about the risk associated with a wide range of securities” (2007, p. 168). As banks no longer intermediate such transactions, information on the credit risk becomes paramount as investors now hold the risk associated with credit default. Given the high costs of individually collecting such information it is unsurprising that institutions have developed to provide centralized judgements of creditworthiness and capture the economies of scale associated with credit evaluation (Sinclair, 1999).

The second type of disintermediation occurs when borrowing takes place in the absence of a financial intermediary. A combination of burdensome banking regulations,²⁷ the inherently high cost of

²⁷ Because the assets and liabilities produced by bank lending appear on the balance sheet of financial institutions they

intermediation,²⁸ and intensified competition has diminished the ability of banks to compete with international capital markets in terms of supplying cheap access to credit. Due to a reduced cost of borrowing and an expanded investor base, issuers are increasingly turning to direct financing in capital markets to raise funds (Gras, 2003). When companies and governments turn to direct financing, credit ratings are necessary because they offer a seemingly unbiased means to signal an entity's creditworthiness to possible investors. CRAs thus play a gate-keeping role in capital markets. By signalling to the market the relative creditworthiness of specific borrowers, CRAs are said to directly affect an entity's cost of, and access to, credit (Sinclair, 2005).

Shifting patterns of investment and borrowing have also contributed to the diversification of financial products available in financial markets. The rise of differing preferred risk/return ratios among investors has resulted in the re-emergence of a vibrant junk-bond market and an accompanying plethora of financial instruments with varying risk levels. While some prudential investors seek low-risk and low-yield investments, others demand high-risk, high-yield investments (i.e., junk bonds). For example, the financial technique of tranching²⁹ -- designed to hierarchically layer credit risk so as to produce differing risk levels -- is used to accommodate investors' differing risk appetites.

Risky debt is increasingly securitized and placed on capital markets. This segment of the bond market has grown rapidly and is valued at roughly \$1.1 trillion. Indeed, high-yield bonds now represent as much as 25% of the US corporate bond market (Reilly, et. al., 2009). The process of credit-risk diversification has transformed international securities markets. The narrowness and exclusivity that characterized the bond market in the era of ratings conservatism, where only the most creditworthy institutions were allowed

are subject to regulations, particularly capital adequacy standards and deposit insurance premiums, which restrict income and increase the cost of traditional intermediation (French & Leyshon, 2004); "The conduct of monetary policy and the interest of regulators in protecting the solvency of the banking system placed constraints on the operations of banks, some of which are very restrictive and costly" (Khoury, 1990, p. 191).

²⁸Intermediation costs money. As Sinclair notes, "banks have to establish and maintain infrastructures to check the creditworthiness of potential borrower[s]" as well as set the terms and conditions of loans and administer and monitor them (1994, pp. 450).

²⁹Tranching is the process in which a special purpose vehicle (SPV), containing various collateralized debt obligations (CDOs), is broken up into different tranches, or levels, which represent different qualities of credit protection. The initial losses incurred from defaults are first absorbed by the lowest tranche. SPVs usually contain three levels: the senior, mezzanine and lower.

to issue bonds, has been replaced by a relatively inclusive debt market with a wide variety of available products (Sinclair, 2005). As the type and riskiness of financial products begins to vary, both individual and institutional investors, faced with an increasingly daunting and costly task of risk assessment, are inclined to seek third-party assistance in making investment decisions. As an illustration, with the rise of non-agency securities in the 1990s, investors began to worry whether they would get their money back and this created an opportunity for S&P and Moody's (FCIC, p. 68).³⁰ Moreover, with the increasing complexity of these securities, market participants worried how anyone was going to understand and buy these products. The solution was to make sure these securities had a credit rating, and this, the Financial Crisis Inquiry Commission (FCIC) argued, "put the rating services in...business" (2011, p. 68).

Due to the diminishing role of banks as financial intermediaries, an information problem has emerged. While lenders need information about whether or not a borrower will wisely use their investment, a borrower has no incentive to disclose any negative information regarding their creditworthiness as this would only increase their cost of borrowing (Kerwer, 2005). This is described as the problem of asymmetric information, a problem that CRAs represent a solution to. By providing an independent assessment of issuers' creditworthiness and supplying that information to potential investors, CRAs act as informational intermediaries, replacing the intermediating function previously played by banks (IMF, 2010). The creation and sale of knowledge has come to displace more traditional bank-based financial relationships (Sinclair, 2001).

Part 3: Banks becoming less Bank-like

In 1998 Geoffrey Miller declared "the obsolescence of commercial banking" (1998, p. 61). Due to the trend of disintermediation, Miller concluded that banks were becoming obsolete. As a result of disintermediation banks did indeed see their earnings from traditional corporate finance and savings, as well as deposits decline. But, contrary to Miller's argument, relative to other financial institutions, banks' profits have not declined. Banks were forced to seek out new profit-making opportunities. As Euturk and Solari describe, "Things had to change...Banking had to rediscover itself: how it worked, the sort of people it

³⁰ These were loans that did not conform to government-sponsored entities' standards (GSE) at the time.

needed to employ, how it intended to serve its customers” (2007, p. 369). The centerpiece of this transformation was the process of securitization. Moving away from traditional bank lending practices, banks began to engage in sophisticated financial engineering and the selling of residential debt in secondary markets (Rethel & Sinclair, 2012). Banks became less bank-like.

Beginning in the 1980s banks began finding new profit opportunities by converting consumer debt into tradable securities and then selling those securities on the secondary mortgage market (Blackburn, 2008). This change has been described as a shift from relationship banking -- where banks focus on establishing long-term relationships with clients -- to a transaction-based banking model that aims to originate and package as many loans as possible in order to earn fees.³¹ Examining the net income of US banks, Allen and Santomero (2001) describe a decline in income generated by interest and a corresponding rise in fee-driven income, such as trusts, annuities, mutual funds and transactions services. Moreover, an increasingly large portion of banks’ income is now from the trading of derivatives and securities on their own account (Panitch & Gindin, 2012). Erturk captures this transformation: “Bank branches of the 1970s were dominated by the long counter across which money was paid in and out by bank clerks...In the early 2000s bank branches are dominated by the cubicles and work stations where advisers sell financial service products like mortgages and pensions” (2008, p. 9).

Under this model banks originate loans for the purposes of pooling them together and selling them on to other funds and banks (McVea, 2010).³² In this way highly illiquid assets can be converted into more liquid, tradable and therefore profitable financial instruments. Throughout the Subprime Crisis mortgage securities made up 18% of the debt markets, overtaking US Treasury bonds as the single largest component (FCIC, 2011). Banks transferred such assets into special purposes vehicles (SPV) so as to avoid legal liability

³¹ This shift is also commonly described as a shift from an originate-to-hold model of banking to an originate-to-distribute one.

³² The American subprime mortgage market is a good example of this process and its dire consequences. Banks originated loans creating residential mortgage-based securities (RMBS), and then pooled them together into collateralized debt obligations (CDOs). Banks then sold these once ‘illiquid’ assets to investment banks, who not wanting to hold onto the risk placed these assets into a special purposes vehicle (SPV) (Rousseau, 2009). The SPV would then be broken up into different tranches or risk levels. The rationale for this process lay in the distribution of risk: by distributing the risk financial institutions were able to offset the risk of potentially destabilizing credit defaults.

in the case of default. Moreover, as SPVs do not fall under the Federal Reserve's regulatory purview, these activities remain off the balance sheet and banks are not restricted by regulations such as reverse requirements. This had the distinct consequence of eroding the traditional bank function of prudentially assessing borrowers' creditworthiness. As banks' income becomes increasingly fee-driven, their incentive to prudentially assess borrowers' creditworthiness is significantly reduced. This is seen in the increasing amount of subprime mortgages originated by banks, which reached a high of 23.5% of all mortgages in 2006 (FCIC, 2011). Thus, in seeking to offset losses that resulted from disintermediation, banks have relinquished their role as quasi-public intermediaries.

The process of securitization has led to the proliferation of structured financial products that reached a total value of \$9 trillion in 2007 (Coval, Jurek & Stafford, 2009). The growth in such financial products was enabled by the massive expansion of subprime leading -- from 190 billion in 2001 to 600 billion by 2006 -- and an increasing percentage of subprime loans being securitized, which grew from 50.4% in 2001 to 80.5% in 2006 (Carruthers, 2010). The growth in securitized financial products was crucial to the growing demand for credit ratings. The rating of structured financial products became the rating agencies' largest source of income—accounting for 44% of all Moody's ratings revenue in 2006 (Coval et al., 2009). Between 1999 and 2007 Moody's revenue from structured financial products rose from \$172 million to \$891 million—an increase of 415 percent (Hunt, 2008).

Conversely, credit ratings have also been instrumental to the growth of structured finance. Securitization is, and always has been, a ratings-driven product (Hunt, 2009). Products are designed to satisfy the established arbiters of credit quality—the rating agencies. Both tranching and the purchasing of credit default swaps (CDS) are examples of techniques designed to secure higher credit ratings for financial products. Not only are products specifically designed to receive higher ratings, but the rating agencies themselves were involved in the creation of these financial products. They would specify in negotiations the components that would allow a high percentage of the securities being issued to garner AAA ratings (White, 2009). This meant, as MacKenzie notes, “the securities themselves and the knowledge of the security were thus co-produced” (2011, p. 1795). The CRAs did not simply react to changes in financial markets, they

actively contributed to them.

The transformation of commercial banking, along with the global financial environment, has been accompanied by profound changes in information gathering and risk management (Lapavitsas, 2011). The consequences of a transaction-based model of banking are an increase in systemic risk, market uncertainty and the proliferation of highly complex financial products as illustrated by the recent Subprime Crisis. The transformation of illiquid assets into tradable commodities results in massive amounts of liquidity being injected into capital markets, thus greatly increasing the volume of market transactions. Moreover, given the highly complex nature of financial products, financial transactions have become increasingly difficult for an average investor to fully understand (Whiteside, 2006). The emergence of such complex financial instruments created a growing need for reliable information on risk assessment (Kruck, 2011). As the FCIC states, “This complexity transformed the three leading credit rating agencies...into key players in the process, positioned between the issuers and the investors of securities” (2011, p. 43).

Conclusion

The liberalization and deregulation of national economies has triggered the rapid expansion of global financial markets. Accompanying this expansion has been the radical transformation of the banking and financial industries, as captured by the trends of disintermediation and securitization. These trends have diminished the role of banks as financial intermediaries and heightening the complexity and volatility of financial markets. As a result, CRAs, having the *perceived* expertise necessary to analyse these complex financial instruments, have emerged to fill the role of the financial intermediary left by banks.

While changes in financial markets have heightened the need for various institutions of credit evaluation, why have CRAs in particular come to dominate this market? And why, given their historical record of failure, are CRAs *perceived* as having the necessary expertise for a role? CRAs represent one among a number of institutions that produce credit-related information: export rating agencies; credit registers; investment banks; and the financial press are all examples of institutions that provide information on financial risk (Whiteside, 2006). Given the multiplicity of information sources, the idea that there is no

alternative to CRAs in a disintermediated financial environment is problematic. As Dieter Kerwer points out, by focusing solely on economic trends and criteria of market efficiency it is “hard to demonstrate [why] in the face of these heterogeneous sources...rating agencies would be able to effectively monopolise the cognitive constitution of the credit relationship” (2001, p. 6).

A number of constructivist scholars from science and technology studies (STS) have pointed out that technological developments are inherently underdetermined. While there may be a need for certain technological developments to solve a problem, there are generally a number of workable solutions to that problem. The choice between these solutions is made by actors using social and political criteria (Feenberg, 2010). Thus, while changes in financial markets may have stimulated the need for certain institutions of credit evaluation to develop, the particular form they take, and the power granted to them, remain underdetermined by technical criteria. While changes in financial markets are necessary to discuss, they insufficiently explain why CRAs have been able to consolidate their power amongst alternative and equally viable institutions. In order to correct this limitation, the political and social aspects of CRAs’ power will be explored. As such, the next chapter will discuss the political component of CRAs’ power. It focuses specifically on how states, particularly the United States, have incorporated credit ratings into market regulations for strategic purposes.

Chapter 4: Private Ratings, Public Regulations

Introduction

Contemporary accounts of financial globalization often see finance as once the servant of the state, and now its master. For example, a recent article in *The Guardian* was entitled “Finance should be our servant not our master” (Goyder, 2012). This discourse is often achieved through the historical juxtaposition of the Bretton Woods era, characterized by embedded liberalism and state interventionism, with contemporary deregulated, disembedded and seemingly “free” markets. Like a phoenix risen from the ashes, as the narrative goes, “global finance took flight and soared to new heights of power and influence in the affairs of nations” (Cohen, 1996, in de Goede, 2005, p. 3). Financial markets are seen as being unleashed from state control and as becoming a structural constraint in the international system, eroding national sovereignty and the space for domestic policy intervention.

The assertion that the rise of financial markets is eroding national policy autonomy implies a simple zero-sum trade-off between state and market power. This perspective cannot account for a situation where states actively promote, encourage, and benefit from, the development of financial markets, such as the Euromarket. Moreover, it assumes the unproblematic existence of financial markets as self-regulating and self-contained entities (de Goede, 2005) and thereby neglects the role of the state in producing and maintaining the necessary legal, institutional and discursive conditions for the globalization of financial markets (Helleiner, 1996). Markets are not abstract economic processes that spontaneously emerge, but are highly developed institutional structures, created, shaped and maintained by a confluence of state and non-state actions. States and markets are therefore not fundamentally separate entities. As such, the privatization of financial markets should not be viewed as the state giving up its once sovereign prerogative, but as an act of governance itself. As Gramsci observed many decades ago:

Free trade movements are based on a theoretical error...on a distinction between political society and civil society, which is made into and presented as an organic one, whereas in fact it is merely methodological...since in actual reality civil society and the state are one and the same, it must be made clear

that *laissez-faire* too is a form of state ‘regulation’ introduced and maintained by legislative and coercive means. (Gramsci, in Fontana, 2006, p. 32)

In line with such observations, this chapter will discuss the state’s role in empowering CRAs, who are traditionally understood as a private actor. The authority of CRAs is not solely a private construction. Rather, states have played an instrumental role in empowering CRAs and their judgements. Through the incorporation of credit ratings into financial market regulations, states have essentially granted CRAs *de facto* legal recognition. This chapter will discuss the ways in which not only the US government, but also governments around the world, have empowered and legitimized CRAs by institutionalizing them into the regulatory frameworks that govern financial markets. An historical account of the regulatory use of ratings and its consequences is followed by an examination of why states have chosen to empower CRAs. Finally, the emerging idea that CRAs’ power relies *solely* on the regulatory incorporation of ratings is questioned. The aim of the chapter is not to argue that states are solely responsible for the power CRAs now wield.³³ Rather, the aim is to argue that by abandoning the state-market dichotomy we are able to more fully understand the power and influence of CRAs.

Part 1: A state-market alliance, ratings in regulation

The first regulatory use of credit ratings was in 1931 when in the aftermath of the 1929 Wall Street Crash, the United States Treasury Department began using credit ratings as benchmarks for limiting banks’ exposure to risk. Banks were prohibited from investing in speculative-grade investment securities, as determined by recognized rating manuals (a speculative security is a security that falls below investment grade: BBB-). With these regulations in place, banks were no longer free to act on information about investments from any source they deemed reliable. They were instead, as Lawrence White points out, forced to use the judgements of recognized rating manuals: “The creditworthiness judgements of these third-party raters had attained the force of law” (White, 2010, p. 213). These regulatory changes provoked an explosive backlash from the banking community; of the 2,000 listed and publically traded bonds, only

³³ This view, termed the regulatory license view (in contrast to the reputational capital view), argues that credit ratings are valuable not because they are accurate and credible, “but because they are key to reducing costs associated with regulation” (Partnoy, 1999, p. 683).

1,000 met the definition of investment grade. The Treasury had thus effectively halved the number of bonds banks were able to purchase (Partnoy, 1999).

Worrying that existing references to organized ratings manuals were too vague, the Securities and Exchange Commission (SEC) introduced the notion of nationally recognized statistical ratings organizations (NRSRO). NRSRO would be the only bodies that could produce ratings compliant with legislation. The SEC crystallized the centrality of the three rating agencies, Moody's, S&P and Fitch, when it declared them the only firms recognized as NRSRO (While, 2010, pp. 692-693). The NRSRO status has subsequently been widely criticized for reinforcing an oligopolistic market structure, increasing barriers to market entry, and reducing economic incentives to avoid misbehavior (Kruck, 2011). It has also been accused of promoting a false sense of security among bond purchasers. As Senator Coburn argued in a 2010 hearing, "the NRSRO designation had become for many investors a government seal of approval" (Mullard, 2012, p. 79). Tellingly, the protesters of the 1930s argued that legislatively sanctioned ratings would "lull banks into a false sense of security that they could safely buy and hold a bond, based on its credit rating, even though such ratings were based solely on past performance and were not necessarily accurate predictors of future performance" (Partnoy, 1999, p. 690).

Following the birth of the NRSRO concept the regulatory use of ratings expanded drastically in both scope and significance (Bruner & Abdelal, 2005). This cascade of regulation resulted in at least eight federal statutes, 50 federal regulations and 100 US state laws and regulations referencing credit ratings as benchmarks for regulating risk (Kruck, 2011). One study observed that 74% of purchases made by a sample of US investment fund managers and 78% in the European sample were subject to minimum-rating requirements (Cantor, 2004). By the 1980s the geographic expansion of ratings-based regulations was well underway and could be found in most countries in the developed world (Kerwer, 2005). This trend is nonetheless geographically uneven, with the highest concentration of ratings-based regulations in Europe and America (IMF, 2010).

Three main types of ratings-dependent regulations are prominent. Firstly, regulators from the 1930s

onwards have used credit ratings as a risk-sensitive means to legally restrict the risk involved in investment decisions. Not only banks, but also pension funds, for example, are required by law to only invest only in securities rated investment grade or above. Secondly, differential disclosure requirements for the issuing of bonds and securities are determined by credit ratings. Firms with a high credit rating are not required to disclose as much information on the underlying composition of the securities they issue. Finally, credit ratings are used to determine capital reserve requirements for commercial banks—that is, the minimum amount of consumer deposits that a bank must hold as reserves, rather than lend out.

While beginning in the US, the use of credit ratings to determine reserve requirements has recently been internationalized with the second Basel Accord, as issued by the Basel Committee on Banking Supervision (BCBS) (King & Sinclair, 2003). The Basel agreement stipulates that if banks are unable to conduct adequate internal risk assessment they are required to use an External Credit Assessment Institution (ECAI), i.e. an approved CRA. While Basel Committee agreements are not legally binding, they nonetheless remain one of the most successful sets of global finance standards (Kerwer, 2006). Ratings-based banking regulations were incorporated into the national regulations of eleven out of twelve countries that make up the Basel Committee, with the exception of Germany (Sinclair & King, 2003). New Zealand has also recently mandated the use of credit ratings for all non-bank deposit takers (NBDTs). In addition, banks operating in New Zealand are required to publically display their credit ratings on their websites.

The internationalization of ratings-based regulations can be partly attributed to the status of the US as the world's largest net exporter of private capital. In 2006 the total financial assets of the US equalled \$56.1 trillion, roughly one third of the global total (Bruner, 2008). Termed the California effect, the regulatory use of credit ratings in the US has repercussions elsewhere because the US capital markets are the most important in the world and, as such, no important borrower can ignore this regulatory setup (Kerwer, 2005). Additionally, the world's largest institutional investors are located in the US, like the California pension fund whose assets total approximately \$180 billion. Because these institutions are subject to minimum investment requirements, they cannot purchase a security that has not been rated or a security rated below investment grade. Thus, if companies are not rated by the NRSRO, or are given a poor

rating, they are effectively excluded from tapping into the world's largest source of private liquidity. The US-based CRAs are therefore acting as legally sanctioned gatekeepers of the US credit market.

The use of credit ratings in regulations has created a situation where CRAs are no longer dependent on their reputation for accuracy or reliability as the sole source of demand for their products. The regulatory use of ratings has created an artificial lift in their business. Market participants are no longer free to choose whether or not to use credit ratings because they are forced through threat of legal sanction to use them (Partnoy, 1999; Hunt, 2008). This creates a situation where there is a dissociation of market and reputation, thus removing various incentives to avoid misbehavior. Traditionally, as the demand for credit ratings has been *theoretically* tied to their reputation for accuracy, CRAs have been disciplined by the desire to produce accurate ratings in order to maintain demand for their product. As credit ratings are incorporated into regulations such market-based mechanisms of discipline are sacrificed. As a Moody's analyst observed, "[As] growth in demand for ratings is not only due to natural market forces, but due to artificial demand for ratings mandated by regulation, ratings no longer function as opinions to be taken or left by investors, and market discipline is accordingly sacrificed" (in Bruner & Abdelal, 2005, p. 202).

CRAs are not private companies who have wrested power from governments. Governments have both valorized and codified the authority of CRAs (Bruner & Abdelal, 2005). Governments have secured the demand for their products, publically validated a handful of agencies through the designation of NRSRO status, and legitimized the practice of credit rating itself by deeming it an acceptable mechanism for public regulators to evaluate and monitor credit risk. States have accordingly played a significant role in empowering CRAs. As states have not delegated any pre-existing government task to CRAs, the generic rubric of privatization, and its embedded state-market dichotomy, is unhelpful. The credit rating business emerged in the private realm with no pre-existing public counterpart. As John Ruggie observes, the process of regulatory privatization has been somewhat overstated; in many cases there is no actual shift away from public to private sectors: "Firms have created a new world of transaction flows that did not exist previously, and which could not have come into being without a new global public domain of transnational discourse" (2004, pp. 503-504). As David Beers, S&P's former head of Sovereign Rating, comments, credit ratings are

“based on a common language of risk that we at S&P helped to invent” (in Bruner & Abdelal, 2005, p. 193).

It is not so much the delegation of public tasks to private institutions, as it is the adoption of private authority inside the public arena. This has been described as a process in which private authority emerges *inside* the state, creating a hybrid form of authority that is neither fully public nor private (Sassen, 2005; Abdelal, 2007). As Bruner comments, the rating agencies represent “an under-theorized regulatory structure in which traditional distinctions between State and market, public and private power, hard and soft law, and international and domestic policy realms, essentially collapse” (2008, p. 125). In recognizing the hybrid nature of CRAs’ power, Bruner notes that it is “difficult” to describe the relationship between states and CRAs “due to the fact that the form of authority that they represent comfortably fits neither the conception of the ‘state’ nor the conception of the ‘market’” (2008, p. 167). Bruner’s difficulty is based on the theoretical error that was identified earlier: states and markets are not separate, nor necessarily antagonistic, entities. This renders irrelevant the debate as to whether CRAs’ power is public or private. The view that regulation and reputation are separate theoretical explanations is “misleading, if not erroneous, given that a synthesis of the two has a stronger explanatory power” (Whiteside, 2006, p. 2).

The complementary interplay between public and private actors that has produced the power of CRAs puts into question the prevailing theoretical dichotomies between the state and market, public and private, and the global and national. These spheres are traditionally seen as existing independently from one another, and as maintaining an antagonistic relationship. The market and state regulations are not pulling in opposite directions. As Tsingou argues, “Going beyond sterile distinctions of public and private enhances our understanding of global financial governance and reveals that public and private are working together to get markets to operate in a certain manner” (2004, p. 13). In relation to state-CRA relations Sinclair notes, “The dynamic between rating agency outputs and governments suggests that state-rating agencies relationships are not purely conflictual or dichotomous” (2005, p. 22).

Part 2: Why Empower Rating Agencies?

This section will highlight the causes behind the regulatory use of credit ratings. Four factors are highlighted. First, and representing the dominant rationale given by politicians, public regulators are said to lack the essential resources necessary for coping with financial market uncertainty in a risk- and time-sensitive way, and have therefore delegated the task to CRAs. Second, the delegation of authority to CRAs reduces the domestic political accountability of states, specifically in the domain of financial market governance. Third, the regulatory incorporation of ratings serves to embed a broadly neoliberal system of economic governance by institutionalizing the judgement of pro-market actors. Finally, the prevailing inter-subjective consensus surrounding the expertise of rating agencies can be said to have promoted their regulatory use. This, however, will be discussed in the fifth and sixth chapters.

A Resource Dependence View

A number of scholars have argued that the regulatory incorporation of credit ratings represents a logical response to the heightened complexity of global finance and the limited capacity of states to keep up with the resources and expertise of the private sector. Financial market regulators “on their own would not be able to collect and process the necessary information to assess the credit risk of all borrowers they seek to regulate” (Kruck, 2011, p. 71).³⁴ As Gavras argues, governments’ reliance upon CRAs represents an indirect recognition that national regulators may “lack the capacity to understand, assess, supervise, and enforce regulation on global institutions with global operations, trading their products on global markets” (2010, p. 478). The spatially fixed nature of state-based instruments of economic governance are said to have become inadequate in a world of global capital flows. Using credit ratings for regulatory purposes makes risk regulation more flexible and thus more likely to adequately address risks. Trading control for effectiveness, government regulatory agencies therefore rely on CRAs in order to more efficiently and effectively achieve organizational goals of market stability and supervision (Kerwer, 2005).

A number of authors have highlighted similar resource-dependencies occurring in other domains of

³⁴ Kruck’s ‘resource dependence’ thesis, while relying on the cost/benefit calculus of policy makers, also incorporates broader ‘structural changes’ in the global political economy; he highlights the trends of financial securitization and disintermediation, as discussed in the first section.

financial market regulation. Underhill and Zhang (2008) argue that financial globalization has rendered public regulators more dependent on private actors in order to adequately regulate securities markets. Discussing the International Organization of Securities Commissions (IOSCO), the authors describe it as an example where rapid financial innovation and technological development have resulted in public regulators becoming more dependent on the knowledge and expertise held in the private sector. Likewise, Stefano Pagliari describes regulators' scepticism in the early 2000s regarding the viability of regulating hedge funds, derivatives markets and CRAs. Their complexity was described as imposing "insurmountable difficulties" for regulators to understand, and "many doubted that regulators could keep pace with the continuing evolution of these innovative markets" (Pagliari, 2012, p. 48). Finally, Tsingous (2008) explores the development of banking regulations under the Basel II agreement and argues that as regulators attempted to develop dynamic and risk-sensitive regulations they came to a similar problem—lack of public sector resources and expertise:

The complexity and speed of financial innovation has put banks in a privileged position as knowledge holders. Public authorities lag behind in terms of technical capabilities and expertise. If regulators and supervisors cannot keep up (and cannot afford to keep up) with the development of financial products that are complex, often tailor-made and used by a variety of institutions and firms, they cannot regulate or supervise effectively. (Tsingous, 2008, p. 64)

As financial globalization has heightened the resources and expertise necessary to regulate financial markets, public regulators have chosen to adopt market-oriented approaches to regulation, supervision and risk management (Underhill & Zhang, 2008, p. 641). The justification for this delegation of authority, or rule-making capacity, lies in the notion that private financial actors have a strong incentive to regulate themselves in a way that maximises the efficiency of financial markets as a whole. Since markets are said to know no boundaries, solutions emerging from market processes are likely to be more politically neutral and cosmopolitan.

While resource-dependence explanations are useful in highlighting the perceived difficulties regulators now face under conditions of rapid financial innovation, they are insufficient. They are unable to explain the existence of such an underlying agreement between policy-makers and private sector officials

on private and market-based regulations. Market-based regulation is not only seen as necessary, but is generally preferred by policy makers (Tsingous, 2008). Moving behind the analytic confines of efficiency, the political motivations behind the delegation of authority to CRAs will be discussed.

The Politics of Credit Rating

The key rationale given by politicians for the regulatory use of ratings is that credit ratings offer a better means to measure credit risk than governments are capable of. Yet, the question should be asked: is there an actual resource dependency, or has the *idea* of one been constructed? We should remain wary of assuming that private expert knowledge is necessary for successful financial governance. If, as Foucault suggests, knowledge is power, the idea that public regulators require private actors to adequately regulate financial markets is significant, and should not be taken for granted. Indeed, the recent Subprime Crisis illustrates the questionable nature of private sector expertise and its limited capacity for self-regulation.³⁵ Some authors argue that the discursive power of business has “purposefully constructed” the image that without its knowledge-intensive resources effective regulation would not be possible (in Graz and Nolke, 2007, p. 236). While a valuable insight, this assumes that discourses of private power are by definition private constructions. Discourses of private power can, in fact, be strategically useful for states; states can therefore often be involved in their construction. The discursive construction of CRAs’ expertise is an example.

The regulatory and discursive empowerment of CRAs is a political strategy used by states to avoid domestic political accountability for the governance of financial markets specifically and economic policy more generally. The regulatory use of credit ratings has produced a dissociation of power and accountability—an accountability gap (Bruner & Abdelal, 2005). While governments empower CRAs they are unable to be held accountable for wrong judgements. Governments do not produce the ratings, only the framework dictating their importance; they instead rely on experts to get the substance right (Kerwer,

³⁵ Reliance upon the expertise of the CRAs was arguably a leading cause of the Subprime Crisis (Partnoy, 2009). Prior to the crisis the rating agencies rated some \$4.3 trillion worth of structured financial products “AAA” (roughly 10,000 securities). Around 90% of these securities were downgraded below investment grade after July 2007. It thus became clear that the credit ratings given to these products vastly underestimated the risk involved in these complex financial products, and that the private sector regulators had vastly overestimated CRAs’ expertise (Mullard, 2012).

2001).

The reliance upon such experts permits policymakers to distance themselves from domestic political fallout when the regulation of credit risk goes wrong, effectively “piggy-backing on the decisions of others” (Bruner & Abdelal, 2005, p. 209). King and Sinclair (2003) describe the regulatory use of ratings as a way for the formal political system to distance itself from the increasing uncertainty of globalized markets. The Enron collapse is an example. Congress and the SEC called hearings, investigated, and berated the agencies, querying whether ratings-dependent regulation makes sense in the future, albeit “without digging too deeply into whether incorporating them in the past was simply a bad decision in the first place” (Bruner & Abdelal, 2005, p. 209).

The use of CRAs as a domestic political scapegoat is also illustrated in the aftermath of the Subprime Crisis. Similar to the Enron example, following the crisis a widespread under-appreciation of the state’s involvement in the empowerment of CRAs prevailed. US congressman Henry Waxman captured the prevailing narrative: “The story of the credit rating agencies is a story of a colossal failure. The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent objective assessments. The rating agencies broke that bond of trust” (Morgenson, 2008). While CRAs came under considerable criticism for their role in the crisis there was little mention of the way in which a number of legislative decisions by federal, state and local governments gave their judgements de-facto legal recognition (Sinclair, 2010; Kruck, 2011), or how the regulatory use of ratings added substantially to herding in the early stages of the crisis.³⁶

The fact that governments routinely obfuscate their authority in financial markets is no accident. As Louis Pauly argues, “Blurring the lines between public and private, indeed, is part of an intentional effort to render opaque political responsibility for the wrenching adjustments entailed in late capitalist development” (2002, p. 77). The prevailing discourse of private companies and institutions dominating the financial markets in America meant that following the Subprime Crisis it was Wall Street, not the Federal government,

³⁶ An example being the legal rules governing pension funds which meant that if ratings went below “investment grade” their selling was mandated by law; in times of financial distress this can produce significant herding effects.

that was subject to widespread criticism.

The conflation of public and private power that characterises the regulatory use of CRAs enables the US government to maintain decentralized control over a core regulatory function while cultivating the perception of a “hands-off” approach (Bruner, 2008). CRAs can therefore be described as what Coen and Thatcher (2005) term non-majoritarian regulators (NMR)—entities that act as intermediaries between governments and consumers. NMRs are unelected bodies who are organizationally separate from governments and have powers over the regulation of markets through formal or informal endorsement by public bodies. We cannot confuse the rise of private power with the decline of the state. The state, along with the way it governs, has radically changed: it now often governs in conjunction with, rather than against, private actors. It now consists of a highly heterogeneous network of organizations and partnerships, many of which enjoy significant levels of autonomy from elected politicians (Flinders, 2005). This has considerably blurred the prevailing analytic distinctions between the public and private spheres. Following such logic, Tony Porter (1999) describes the regulatory incorporation of credit ratings as a decentralized regulatory technique more compatible with late-modern knowledge structures. This type of regulation is based on the creation of generalized principles that structure the “flow of credit” and alter the knowledge production process in markets in order to enable the state to “regain some part of the control that has been lost as centralized regulation is abandoned” (Porter, 1999, p. 143).

The regulatory use of credit ratings for purposes other than their accuracy is a common theme in ratings history. The rise of CRAs in the 1930s had little to do with their performance at the time. Moody’s suddenly downgraded 80 percent of sovereign debt in a week following the sterling crisis in 1931. Furthermore, credit ratings were used widely in the marketplace long before anyone even knew precisely how useful the ratings were. The first major collaborative study testing the accuracy of credit ratings did not emerge until the 1950s (Carruthers, 2013). Their regulatory use had much more to do with regulatory intervention in the US to assuage fears of conflict of interest among bankers (Flandreau, 2012). The state-sanctioned function they performed was “diverting the flow of public opprobrium away from the bankers” (Flandreau, 2012, p. 18).

The contemporary empowerment of CRAs can be seen as a means to entrench and expand neoliberal globalization. Gill's notion of new constitutionalism is a useful approach to highlight the changing role of the state and its new techniques of governance in an era of neoliberal globalization. New constitutionalism denotes a quasi-legal restructuring of the state used to confer privileged rights on transnational capital and lock in governments to market-based values and disciplines. A central purpose of new-constitutionalism is to redefine the relationship between the political and the economic, and thus reconstruct the terms through which political action is possible in a capitalist society (Gill, 2002, p. 47-48).

In order to provide a basis for assessing the delegation of authority to CRAs through new constitutionalism, the neoliberal disposition of CRAs must be discussed. Relying on the methodological separation between markets and politics, neo-classical economists depict CRAs as simple conveyer belts of market information devoid of political preferences. Illustrating this view, Lord Dartmouth of the UK Independence party discusses the complaints laid against the CRAs in the wake of the Eurozone crisis; it is nothing but "shooting the messenger", he argues. There are fiscal problems within the EU countries and this is a "fact that S&P and other credit rating agencies report...politics is not within the credit rating agencies. It is with the leaders of the Eurozone countries" (Dartmouth, 2011). An exploration into the sovereign rating process debunks such apolitical descriptions and their omission of power, preference and ideology.

The failure to see the political nature of CRAs' judgements, and global finance more generally, results from orthodox depictions of global financial markets by neo-classical economists. Orthodox definitions describe global finance as all types of cross-border portfolio-type transactions or flows, and this myriad of financial transactions circulating the globe is said to constitute a distinct sphere of global finance. Such depictions, however, only capture half the story, as they "miss out the formative stages, the process and practices that shape and generate the flows and the circulation" (Pryke, 2006, p. 7). Orthodox definitions establish financial markets as pre-established objects of enquiry, highlighting only the end product of a complex process of credit creation, and thereby obscuring the ways in which the transactions themselves are produced (Germain, 2004). Political contestation over what *is* an appropriate financial order

has been marginalized by a neo-classical discourse that reifies the market as the “rational” and “natural” institutional locus for the international organization of credit, and thus obscuring the inherently subjective and political nature of the contemporary governance of financial markets (Langley, 2008).

The idea that solutions emerging from the market are more politically neutral and cosmopolitan obscures the territorially embedded and political nature of market actors and judgements. Such assertions rely on the argument that due to the revolution in information communication technology (ICT), financial liberalization and increasing capital mobility, geographic location no longer matters in finance (O’Brian & Keith, 2009). The idea of deterritorialized economic transactions obscures the extent to which governance of the global economy is geographically and institutionally embedded (Sassen, 2000). World financial centres, predominantly New York, represent key social spaces for the generation of world credit practices (Langley, 2005). From the 1980s onwards, the global financial system has witnessed an asymmetric dissemination of US-derived financial practices and regulatory standards characterized by the progressive financialization of credit (Konings, 2007). Consequently, it is necessary to recognize “the inescapable geographic construction, context, and rootedness of financial networks and practices” (Pike & Pollard, 2010, p. 38).

With what little attention there is on the sources and consequences of financial flows, the focus is on the destabilizing impact of short-term capital flows and monetary policy (Germain, 1997). A situation of benign neglect exists regarding the sources, structure and impact of long-term capital movements. In the *International Organization of Credit* Randall Germain (1997) seeks to correct this theoretical deficit; he criticizes the current academic focus that neglects the way in which long-term credit is made available to certain actors, and the impact particular forms of long-term credit allocation have on how the international political economy is organized. Germain uses the term credit instead of finance to highlight the key question of finance: gaining access to credit. As he explains:

Credit here is a resource which people, firms, and governments have access to at the discretion of others, and at a cost established by others: it is both a material resource and a set of social practices associated with realizing it...The social and political implications of credit thus concern who controls the access of others to

credit, who is privileged by access to credit, and who reaps the competitive advantage which access to adequate credit imparts. (1997, p. 17)

In highlighting the often forgotten elements of power embedded in the process of long-term credit creation and allocation, CRAs' power and the inherently political nature of their judgements are brought to light. The delegation of authority to CRAs redefines the relationship between the political and the economic. Entrusting the decision of how capital is allocated to market-based mechanisms removes it from political deliberation and reaffirms the objective and apolitical task of credit evaluation. The questions of what it means to be creditworthy and how capital is to be allocated in society are depoliticized. As Sinclair states, rating agencies offer governments a vehicle "through which parts of society, such as capital allocation, can be separated off as not political" (1999, p. 498). As Chapter 8 will make clear, the privatization of financial governance is a strategy used by governments to circumvent parliamentary and civil society contestation and opposition to market-friendly policies. The aim is to "further insulate seemingly technical issues of financial governance from broader discussion" (Kruck, 2010, p. 17).

As an example of the overtly political nature of regulatory architecture surrounding the credit rating process, the NRSRO status has been criticized for supporting the political interests of the United States. In September 2010 a confrontation between the SEC and the Beijing-based CRA Dagong Global occurred when the SEC rejected Dagong's application for NRSRO status on the grounds of cross-border oversight issues. Accusing the SEC of bias, Dagong Global argued that "The SEC's deliberate denial is evidently aimed at preventing Dagong from gaining influence in the international credit rating market, and at maintaining the monopoly of three U.S.-based major credit rating agencies...it is a barrier specifically set for Dagong, which is obviously discriminatory against China and the Chinese rating agency" (People's Daily Online, 2010). Tellingly, in 2012, nine of ten rating agencies with NRSRO status were American companies (SEC, 2012). The confrontation between Dagong and the SEC illustrates not only the political nature of credit evaluation, but also the role that American interests play in constructing and maintaining the regulatory architecture surrounding the rating process.

The rating of sovereign governments is the most contentious and subjective aspect of the credit

rating process. While rating agencies disavow any ideological content in their ratings, this is implausible, particularly in light of the evaluation of economic policy that lies at the heart of sovereign rating (Bruner, 2008). The neoliberal underpinnings of the CRAs' judgements have been well noted by academics. Attesting to the geographically embedded nature of global finance, Bruner and Abdelal describe CRAs' judgements as reflecting a US-centric, neoliberal ideology, with "roots in New York's financial community" (2005, p. 199). For Sinclair, CRAs embody orthodox theories of US finance and lie at the "nexus of neoliberal control" (2005, p. 69). Sovereigns with higher ratings tend to demonstrate openness to trade and integration into the global financial system (Bruner, 2008). As S&P states in its primer on sovereign credit rating, "Due to its decentralized decision-making processes, a market economy with legally enforceable property rights tends to be less prone to policy error and more respectful of the interests of creditors than one where the public sector dominates" (S&P, 2008).

The clearest examples of such neoliberal ideological preferences are the agencies' consistent anti-deficit stances and their negative reactions to the imposition of capital controls. During the Asian financial crisis Malaysia imposed capital controls to limit capital flight. Subsequently, Malaysia was downgraded by the rating agencies, the justification being that such policy changes signalled a lack of respect for the rights of investors (Abdelal, 2007). Before and after the Asian financial crisis the rating agencies were said to attach higher weights to their qualitative judgement than they gave to actual economic fundamentals (Giovanni, Liu, Stiglitz, 1999). The downgrading of Malaysia was described as an orthodoxy-driven overreaction as at the time there was, in fact, a lack of consensus among macroeconomists regarding whether Malaysia's actions actually constituted a policy error (Bruner, 2008). The use of capital controls did not destabilize Malaysia's economy, but actually coincided with its economy recovery. Malaysia, for example, was able to recover more quickly and had a shallower downturn than Thailand, which followed the IMF's orthodox prescriptions (Stiglitz, 2002, pp. 124-125).

As the rating agencies have neoliberal policy preferences, by giving CRAs' judgement de-facto legal recognition, states are essentially "locking in future governments to liberal frameworks of accumulation premised on freedom of enterprise" (Gill, 2002, p. 47). The rating agencies are indirectly acting to further

US interest. Indeed, CRAs' rise to power has been inextricably intertwined with the restructuring of the global order under US hegemony. The US-based rating agencies are part of what Haarstad (2012) terms the architecture of investment climate surveillance. Through the neoliberal values embedded in their evaluations the agencies conceptually narrow the range of legitimate policy options available to those seeking access to credit. Because the institutions seeking funds become aware of the potential advantages and disadvantages of certain policies prior to their implementation, the rating agencies help shape their internal organization and calculative rationality (Deuchars, 2004).

Part 3: State-centrism, a simple solution?

Senator Joe Lieberman describes the power of CRAs as simply government-conferred power (in Kruck, 2010). Lieberman's view now coincides with an increasing number of academics, politicians and civil society representatives who argue that CRAs' power is primarily, if not solely, the result of their regulatory use—termed the regulatory license view (Bruner, 2008; Abdelal, 2007; Kerwer, 2001; Partnoy, 1999). According to Bruner (2008), CRAs' power today ultimately derives more substantially from state endorsement of their decisions. For Kerwer, “regulatory enforcement is the key to the rating agencies' power, and not their pivotal role in financial markets, as is commonly assumed” (Kerwer, 2001, p. 3).

These theories generally point to an obvious flaw in reputation arguments. Despite the continual failure of the CRAs' risk assessments – as seen in the Asian financial crisis,³⁷ the Enron collapse,³⁸ and the US Subprime Crisis – the use of credit ratings has nonetheless increased. This, as Frank Partnoy (1999) argues, means that the influence of rating agencies cannot be considered solely an outcome of their reputational legitimacy. There have been consistent and significant blows to the rating agencies' reputations with no corresponding decline in their business. Rather than being dependent on their reputational capital, rating agencies are now dependent on selling compliance with regulation. “Credit rating agencies have not survived for six decades because they produce credible and accurate information...[they] have thrived,

³⁷ The agencies were accused of both failing to predict the crisis, as well displaying pro-cyclical behavior—that is aggravating the financial crisis by under-rating Asian countries, thus increasing their costs of borrowing and causing increasing amounts of capital flight (Ferri, Liu & Stiglitz, 1999).

³⁸ Enron, one of the largest energy companies in the US, was rated investment grade by the three main CRAs four days before it declared bankruptcy (Hill, 2009).

profited, and become exceedingly powerful because they have begun selling regulatory licenses, i.e., the right to be in compliance with regulation” (Partnoy, 1999, pp. 713-714).

Deriving largely from its simplicity, this view has gained considerable support within civil society and governmental organizations; it is significantly altering how governments and NGOs have proposed to reduce over-reliance on credit ratings. Thierry Philipponnat, Secretary General of Finance Watch, responds to a question of how to reduce over-reliance on credit ratings:

There’s a very simple solution. It’s to permit investors to follow the rating agencies’ opinions without being obliged to. We’re in an absurd system today in which, once an agency’s opinion is given, the investor is obliged to follow that opinion. Why? Because the ratings are in the financial regulations. So we have to get rid of all reference to the ratings in the rules so investors can follow the ratings if they want to. They are free to – fine – but are not obliged to. That’s really the key. (Euronews, 2012)

As a result of CRAs being implicated in the US Subprime Crisis as well as the current European debt crisis a number of government regulatory agencies and NGOs have followed this simple solution (Kruck, 2010; IMF, 2010). In October 2010 the Financial Stability Board (FSB) released its “Principles for Reducing Reliance on CRA Ratings”. Reducing reliance on ratings, they argued, will “reduce the financial stability—threatening herding and cliff effects that currently arise from CRA rating thresholds being hard-wired into laws, regulations and market practices” (FSB, 2010, p. 1). References to ratings should “be removed and replaced” and “alternative definitions of creditworthiness developed” (FSB, 2010, p. 1).

At the national level the US led the charge with the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and the 2010 Financial Sector Reform Bill. Christopher Cox, the Chairman of the SEC, captured the prevailing sentiment within the government: “The official recognition of credit ratings for a variety of securities regulatory purposes...played a role in investors’ over-reliance on CRAs” (Cox, 2008). Accordingly, the bills sought to remove all regulatory references to credit ratings; they required all federal agencies to “remove references to or reliance upon credit ratings and substitute an alternative standard of creditworthiness” (in IMF, 2010, p. 95). Following the US example, in 2011 the European Union (EU) established the European Securities Market Authority (ESMA), which was mandated with regulating the

activities of the rating agencies. The EU Parliament's Economic and Monetary Committee subsequently issued draft legislation that stated that "all regulated financial institutions, such as banks, insurance companies, and investment fund managers, would be required to develop their own rating capacities, to enable them to prepare their own risk assessments and thus not rely entirely on external ones" (European Parliament, 2012).

The regulatory license view provides an over-simplified and limited conception of CRAs' power. These critics suggest that modern ratings are being used in the private sector because they have been given widespread regulatory standing, but this is historically inaccurate: wide-spread private use of ratings preceded public regulatory sanctification (Carruthers, 2013). Their view fails to incorporate both wider structural changes in global financial markets as well as various social dimensions of CRAs' power. Despite the implementation of legislation designed to remove all references to credit ratings in regulations in 2010, CRAs continue to play a significant role in financial markets; the total profits of all registered NRSROs went up from \$3.7 billion in 2011 to \$4.2 billion in 2012 (SEC, 2012). In addition, the non-regulatory use of credit ratings is far more significant than implied by the regulatory license view. While regulations required investors to purchase securities rated by one agency, investors consistently favor securities rated by two or three rating agencies over those rated by one agency (Hill, 2009). Thus, while regulations require that one rating be obtained, most debt issuers as common practice seek two, if not three, separate ratings (Langohr & Langohr, 2008).

One of the most significant uses of credit ratings has been their use in private contracts by a number of mutual funds, pension funds and insurance companies, among others. In 2002 Moody's observed that 87.5% of companies whose debt was rated Ba1 or above reported they had rating triggers incorporated into financial contracts (Parmeggiani, 2012). The use of rating triggers – which are contractual provisions incorporated into financial contracts that force borrowers into certain actions following a change in their ratings – have recently gained considerable attention due to the high-profile bankruptcies of Enron and Pacific Gas and Electric Company. In these high-profile cases, when these companies were downgraded they began facing dire liquidity problems because their required payments to lenders increased and their

credit availability dried up. This was not the result of governmental regulations, but because of the pro-cyclical effect of the rating triggers. Indeed, rating triggers also played a role in the collapse of AIG, whose over-the-counter (OTC) derivatives trade was regulated by rating triggers contracts. As long as AIG's financial products maintained AAA ratings they were not required to post collateral. But after the first downgrade (in 2005) they had to start posting. As the crisis unfolded their mounting collateral posting requirements, coupled with liquidity strains, become unsustainable (IMF, 2010).

Another example of the non-regulatory imposed use of credit ratings is in sovereign governments. Most of the world's governments now hold a credit rating. Additionally, a number of governments with no intention of even issuing bonds have sought a credit rating. This group of governments is now in fact driving the growth in sovereign credit ratings (Bruner & Abdelal, 2005). The United Nations Development Program (UNDP) is now encouraging developing countries to obtain credit ratings as a form of poverty alleviation. The UNDP argues that by helping countries integrate their economies into mechanisms of global finance markets, this provides transparency and encourages confidence for investment (in Muhlen-Schulte, 2009). Governments have not been coerced through threat of regulatory sanction to gain a credit rating. Credit ratings are something governments have sought out, even promoted. The power of CRAs must therefore not be conceptually limited to their incorporation into regulation.

The fact that governments have sought credit ratings does not remove questions of power from the equation. Some have misperceived the shift away from structural adjustment policies as meaning that power is now absent in global credit markets. Power has not been removed; it has merely changed form. This type of power is not coercive; rather, it is in line with Foucault's notion of *governmentality*—it operates through “a complex set of instruments, institutions and knowledge that normalise particular behaviours, actions, and ways of thinking” (Haarstad, 2012, p. 83). As Sinclair argues, “a view of rating simply as a coercive force does not capture the whole story”; consideration, he argues, must also be given to the way a rating “shapes, limits, and controls, often in connection with the generation of authority—rather than the brute application of power” (2005, p. 10).

Conclusion

This chapter has argued that CRAs' power is not solely a private construction. Governments have played a significant role in empowering these institutions by incorporating credit ratings into market regulation. In asking why governments have chosen to incorporate these ratings, three aspects were highlighted: the so-called inability of public regulation to keep up with the private sector, a purposeful effort by states to avoid domestic political responsibility in an inherently unstable period of financial capitalism, and a means to embed neoliberal economic reforms. The main point is that discourses of private power are not necessarily privately constructed. States can greatly benefit from the idea that private actors have surpassed their regulatory capabilities and rendered them obsolete in an age of global capitalism. Finally, the idea that the power of CRAs is solely an outcome of their regulatory incorporation was criticized. If states seek out or even promote credit ratings then we must look at not only the coercive aspects of CRAs' power, but also the ways in which they are able to generate authority and consent for their expertise. The next two chapters will therefore explore the social dimensions of CRAs' power.

Chapter 5: The Science of Modern Finance

Introduction

Similar to the neo-classically inspired attempt to remove the state from the analysis of global finance, a large amount of contemporary scholarship depicts financial globalization as being disembedded from wider socio-cultural relations. The increasingly digitized, globalized and deregulated nature of financial markets is said to create a pure market governed solely by instrumental rationality and the pursuit of profit.³⁹ Finance is seen as “disembedding and alienating, an agent that acts *on* social relations, rather than being constituted *by* social relations” (French et al., 2011, p. 12). Representations of financial globalization thus tend to conceive capital mobility as though it were generated by its own natural laws—an automatic, non-social mechanistic process let loose by states (Sinclair, 2001). Such representations are often drawn from an interpretation of Polanyi’s embedded/disembedded dichotomy; while pre-modern economies are said to be embedded in social relations, modern economies are now solely governed by formal economic laws.

These approaches fail to recognize the socially embedded nature of financial markets. A different interpretation of Polanyi’s work, as put forward by Damien Cahill (2011), is that economies are “always embedded.” Cahill (2011), drawing from Polanyi’s later work *The Economy as Instituted Process*, argues that social institutions are always necessary to provide regularity and stability to economic logics. During the first wave of liberalization the economy had to be disembedded from social relations incompatible with the market system before being re-embedded in a new set of compatible, market-friendly and state-facilitated relations. Capital mobility, for example, is just as much a social fact as it is a materially existing reality. This form of pro-market socialization is never complete. Drawing from Foucault, there is always a tension between governmental self-formation – the way in which elites attempt to shape individual subjectivity – and ethical self-formation – the ability of individuals to be critically aware (Rose, 1991).

Economic interactions and practices thus take place in a complex web of social relations. As de

³⁹ David Harvey, Anthony Giddens and Jurgen Habermas, drawing largely from the work of George Simmel, represent some of the more prominent authors espousing such a view of markets and society.

Goede argues, de-socializing narratives “insufficiently recognise that monetary practices, even modern deregulated financial practices, require in-depth social relationships, trust, interpretative communities, and authoritative underpinnings” (2005, pp. xxiv). Rather than depersonalizing economic activity, financial globalization has actually meant social networking has become an even more important activity because of the increased amounts of knowledge of all kinds that now circulate and the need to interpret it (Leyshon & Thrift, 1999). Social values, attitudes and dispositions are now crucial components governing how financial market participants select, interpret, and react to knowledge in the global economy. A number of fields have developed in an attempt to incorporate social and cultural analysis into contemporary finance.⁴⁰ The common approach within these fields resides in the abandoning of the artificial distinction between the economy and society. It, however, is not simply that financial markets are embedded in social relations – as economic sociologists have long stressed – but that culture and markets are joined in loops of co-determination and co-evolution which “make up” the economy (Pryke & Du Gay, 2007). Drawing on such theoretical approaches the next section will discuss how the social dimension of CRAs’ power has been theorized.

Part 1: Traditional approaches to CRAs’ expertise

Credit broadly defined represents a promise to pay; trust is therefore fundamental to all credit relationships (Lapavitsas 2007). Financial networks, Dodd argues, “rely on trust between people who may never come into contact with each other, trust derived from...a complex intermeshing of calculating expectation, confidence, habit and even faith” (1994, p. ix). By way of illustration, 94% of all US securities and 98% of all Japanese securities are purchased locally (Sinclair, 2001). This is described as the home bias and it illustrates the importance of information about, and trust in, parties for investment decisions, as well as the continued centrality of the state as a geographic unit in an era of neoliberal globalization.

As illustrated by the percentage of securities purchased locally, in the domestic setting the requirements for trust have been largely met. Yet, as investment internationalizes, uncertainty becomes

⁴⁰ Some include: the social studies of finance (MacKenzie, 2005; 2006); the sociology of finance (Knorr Cetina & Preda, 2004); and the cultural economy of finance (Pryke & Paul du Gay, 2007).

considerable. Consequently, agents who provide investment information that is perceived to be trustworthy, like CRAs and the OECD, emerge to reduce this uncertainty. They are said to derive their influence from their perceived objectivity and expertise, which generates trust in their investment advice (Haarstad, 2012): “Without this trust in the supposed objectivity and expertise associated with the generation of these [credit] assessments this whole enterprise would most likely collapse” (Deuchars, 2010, p. 118). The agencies themselves have stressed this point: “Our reputation for honesty and integrity is our most valued asset...it is our company’s lifeblood” (Rivero, 2008). Yet, the question remains: how are their reputations for objectivity and expertise constructed?

Earlier theoretical work on private authority draws from the notions of epistemic communities and coordination service firms (Adler & Haas, 1992; Cutler, Haufler & Porter, 1999). These authors describe how one does not have to be *in authority* (i.e., political leaders) to be *an authority* (i.e., technical experts). This type of authority is consent-based and dependent of the perceived legitimacy of the private actor involved. Cutler and colleagues describe private authority as existing when “an individual or organization has decision-making power over a particular issue area and is regarded as exercising that power legitimately” (Cutler et al., 1999, p. 5). Similarly, Hall and Biersteker describe such authority as being built on the legitimacy of private actors’ claim to power, requiring “some form of normative, uncoerced consent or recognition of authority on the part of the regulated or governed” (2002, pp. 4-5).

Such notions are often utilized in order to explain CRAs’ power. As Bruner comments, “observers have often ascribed to the rating agencies’ forms of private market power that can easily be squared with the broadened conception of legitimate authority” (Bruner, 2008, p. 139). In an attempt to develop an account of why CRAs are seen as legitimate private actors, Sinclair (2000) develops the notion of embedded knowledge networks (EKNs), which are private institutions that remain at arm’s length to market transactions and often act as disinterested technical parties. EKNs possess authority because “of their publically acknowledged track records for solving problems”, and because they are seen as being “endogenous” to financial markets (Sinclair, 2000, p. 488). Because CRAs are seen as a natural and disinterested (i.e., apolitical) part of financial markets they are seen as legitimate by market participants.

Following Sinclair's logic, CRAs should not be able to maintain authority if they are considered exogenous political actors. This, however, does not seem to be the case. Following the initial downgrading of its sovereign rating in 1998 the Japanese government publicly claimed that the American rating agencies do not understand Asian business practices (Sinclair, 2000). The Japan Centre for International Finance claimed that "cultural bias" often impairs the judgment of the US rating agencies as they fail to "take into account factors unique to the Japanese corporate governance structure" (Byoun & Shin, 2002, p. 4). In response to such hostility, in 1999 the Japan Centre for International Finance conducted a study in which the elite members of 175 major financial institutions and 89 leading industrial firms were surveyed regarding their thoughts on the rating agencies. Ninety percent of respondents believed that the US rating agencies insufficiently considered specific Japanese factors in the ratings process. Yet, sixty percent noted that "investors place excessive reliance on the information provided by rating companies and tended to abandon their own investment judgement" (Whiteside, 2006, p. 101). Despite the clearly imposed status of the US rating agencies, investors still excessively relied on their judgements as benchmarks for financial decision-making.

In the midst of the European debt crisis European policy makers have also begun to question what they see as the undue influence of the US-based rating agencies. In January 2013, Arlene McCarthy, the centre-left Chair of the European Parliament's Economic Committee, commented that, "credit rating agencies have evolved over recent years from an information service into quasi regulators [*sic*] with enormous influence over market activity" (Fox, 2013). Even in 2004, the European Parliament's Committee on Economic and Monetary Affairs argued that, "the ownership and business orientation of the rating agencies is predominantly centred on the United States" (European Parliament, 2003). Bank managers in Germany have criticized "the colonial attitudes of raters" and their "unwillingness to take into account the special characteristics in European accounting, disclosure, and management practices" (Engelen, 2004, p. 69). As a result of such attitudes, on the 16th of January 2013 the European Parliament signed into law new legislation regulating the CRAs (Europa, 2013); this aimed towards reducing investors' over-reliance on ratings, mitigating potential conflicts of interest and increasing transparency and competition in the sector

(MercoPress, 2013).

While the US agencies are clearly seen as imposed entities governed by US business standards, they nonetheless hold, or at least are perceived to hold, large amounts of power. A number of recent news articles on the role of the agencies in the current Eurozone crisis illustrate this point. Writing for *Presseurop* Nicolas Demorand (2011) comments: “By placing the eurozone under negative watch on the eve of the European Council meeting, Standard & Poor's has confirmed the emergence of a limitless economic power that is overwhelming the structures and rules of democracy.” Other articles include: “Rating agencies take centre stage in euro crisis” (Voigt, 2012); “Credit ratings should not shape EU policy” (RT, 2011); and, “Eurozone crisis deepens after rating downgrades” (Wires, 2012). Politicians have displayed a similar sentiment as evidenced by their attempts to reduce the power of the US agencies. The perception of CRAs having power is significant because CRAs’ judgements “become significant in markets because of the authoritative status market participants and societies attribute to them” (Sinclair, 2005, p. 17). Even if a market participant disagrees with a certain rating, if he believes the agencies are influential or that others will follow their judgements, he too will follow their advice.

As the examples of Japan and Europe illustrate, Sinclair’s notion of EKNs is problematic. CRAs are often seen as imposed and politicized actors, but nonetheless maintain influence. In an attempt to remedy the failure of prevailing theoretical models to sufficiently explain CRAs’ power, this chapter will draw from the sociology of quantification and argue that the particular form of the credit rating, and the methodology said to underpin it, grants CRAs a privileged position as knowledge producers of credit evaluation. As noted in the introduction of this thesis, when examining the role of knowledge in global policies we should not only look at who is producing the knowledge, but also how it is communicated. The evaluation of CRAs’ power must focus on the particular form, function and methodology of the credit rating itself. In doing so a new dimension of state-CRA relations is brought to light.

Part 2: Putting the “Science” in Finance

Rating agencies continue to argue that credit ratings are subjective opinions similar to those expressed in other types of financial journalism. Despite this assertion, the opinions of rating agencies are far more significant and valued than those of even the most highly respected financial publishers (Hunt, 2009). Moody's revenues are comparable with Dow Jones and Reuters despite smaller assets and staff size. Dow Jones employs three times as many people as Moody's, yet Moody's shares are worth nearly five times as much. Each Moody's employee is associated with ten times more market value than each Dow Jones or Reuter's employee: "By virtually any financial measure, Moody's has a much more valuable franchise than other financial publishing firms and is much too profitable to be considered a financial publisher" (Partnoy, 2006, p. 68). Two key differences separate CRAs from their self-proclaimed status as financial journalists. As noted, ratings are incorporated into regulations. Additionally, as will be the subject of this chapter, the way in which rating agencies' *opinions* are expressed significantly differs from alternative forms of financial journalism. The simplistic and easy to understand alphanumerical symbols (i.e., AAA), along with the quantitatively rich methodology said to underpin them, make credit ratings distinct from other openly subjective evaluations of financial risk.

As Moody's states, "because it involves a look into the future, credit rating is by nature subjective...any attempt to reduce credit rating to a formulaic methodology would be misleading and would lead to serious mistakes" (in Rona-Tas & Hiss, 2010, p. 121). Despite this assertion, ratings are often confused with objective indicators of performance. As Jane Kelsey points out, "credit ratings are frequently treated by governments, the media and economic commentators as objective facts" (1999, p. 82). In addition, the methodology underpinning the rating process is often confused as being purely quantitative and objective. Jay Siegel, a former Managing Director at Moody's, testified to the FCIC: "One common misperception is that Moody's credit ratings are derived solely from application of a mathematical process, or a model" (FCIC, 2011, p. 121). This misperception is a direct result of the way in which ratings and the methodology underpinning them are presented by the rating agencies. Credit ratings are alphanumerical representations of what is implicitly conveyed as a numerical and quantifiable financial reality. The rating

agencies assert that credit ratings are opinions, whilst simultaneously seeking to objectify and offer their views as facts (Sinclair, 2005).

While there is a growing recognition that expert knowledge represents a significant component of global governance, there has been little systematic effort to understand the distinctive characteristics of knowledge production and communication that characterize the modern period (Porter, 1999). This chapter will argue that it is not simply the perceived expertise of the CRAs, but the authority given to the type of knowledge they produce and the simple and flexible way their judgements are communicated.⁴¹ Within this chapter, the focus shifts from who is producing knowledge (i.e., CRAs), towards exploring the primary means by which knowledge is being communicated. In an attempt to highlight the significance of these dynamics, the first part of the chapter describes the prominent role that numbers have come to play in contemporary governance. It then outlines the key concepts used in the following sections: quantification, risk/uncertainty and performativity, which are subsequently applied to the development of modern finance in general and credit rating process in particular. The aim is to demonstrate how they resulted in the objectification, legitimization and centralizing of financial decision-making processes.

Numbers in Contemporary Governance

A salient feature of the contemporary knowledge structure is the homogenization of methodological approaches to knowledge production and communication. This structure is centered on the logic of the quantitative method and its representation as a generator of objective facts. In *A History of the Modern Fact*, Mary Poovey argues that numbers have come to seem preinterpretative or even noninterpretative; they have come to “epitomize the modern fact” (1998, p. xxii). The internationalization of investment created considerable uncertainty, and it is numbers and their association with objectivity that has overcome this. Indeed, reliance on numbers minimizes the need for intimate knowledge and personal trust (Porter, 1995, p. ix). Numbers have not replaced interpersonal trust, they have generated it. As such, those who generate them have come to occupy key focal points of power in global politics. As Robert

⁴¹ This will be discussed in more depth later. Suffice it to say, the alphanumerical form of CRAs judgments coupled with their overly-simplistic narratives incited by notions of upgrades and downgrades produces a situation in which the expertise of the rating agencies can be *used* by governments seeking to legitimize certain domestic policies.

Deuchars comments: “We have become surrounded by numbers to the extent that we place a significant degree of uncritical trust in them and to those who represent them as factual” (2004, p. 64). CRAs’ authority is driven from these prevailing characteristics of the contemporary knowledge structure.

Representative of such “trust in numbers” (Porter, 1995) is the increasing public, governmental and scholarly demand for the quantification of social phenomena (Espeland & Stevens, 2008). This has been driven by the colonization of social and political sciences by the methods of neoclassical economics. When Benjamin Cohen (2010) asks, “are IPE journals becoming boring?”, he is echoing a commonly held disheartened sentiment regarding the intellectual monoculture that now characterizes the methodological and interpretative approaches of his field (also see Wade, 2009).⁴² Modern economics is also required to be increasingly mathematical; publication in economics journals now depends on the elegance of the mathematics as opposed to how well it actually explains reality: “Mathematics became economics and economics without mathematics was no longer economics” (Mullard, 2012a, p. 9).

The concept of performativity is central to understanding the discursive underpinning of financial markets. Drawn from the late philosopher J. L. Austin, performativity highlights how language not only describes reality, but can also bring it into being.⁴³ When applied to economics this concept describes how descriptions of economic reality can contribute to shaping that reality. Markets, it is argued, do not exist prior to, or independently of, descriptions of them (MacKenzie, 2006). Economics, as Michel Callon argues, “in the broader sense of the term...performs, shapes and formats the economy, rather than [simply] observing how it functions” (Callon, 1998, p. 2).⁴⁴ MacKenzie (2006) highlights the Black-Scholes model as an example. The model was not originally intended to be an empirical description of the market, but rather a representation of an ideal market. Its purpose is to provide traders with a theoretically correct stock price from which they can compare the actual price. Following the widespread use of the model by financial traders its description of market prices became more accurate in 2005 than immediately following its

⁴² As an example, in the top twelve international relations journals the use of quantitative methods rose from 20% of all articles in 1985 to 90% in 2006 (Maliniak & Tierney, 2009).

⁴³ An often used example is the act of apologizing, as the speaker is not reflecting any pre-given reality, but is bringing one into being.

⁴⁴ By “broader sense of the term” Callon means all activities aimed at understanding and analysing the market (MacKenzie, 2006).

emergence. Understanding finance as a performative practice suggests that processes of knowledge and interpretation do not exist in addition to, or are of secondary importance to, real material financial structures, but are precisely the way in which finance materializes (de Goede, 2006).

Displaying elements of performativity, the quantification of social phenomena is never simply a matter of discovery, but always of administration. Numbers and graphs are strategies of communication (Porter, 1995) at the heart of modern forms of disciplinary power (Espeland & Stevens, 2008). Quantification makes people, objects and characteristics visible that may formerly have been invisible, and which are subsequently able to be disciplined (Espeland & Stevens, 2008). Neither society nor the economy existed until various systemic attributes related to these entities were measured: crime in the case of the former and GDP in latter (Rose, 1991). GDP is now one of the most significant economic performance indicators through which economies are judged. As Miller and Rose point out, “technical devices such as writing, listing, numbering and computing render a realm as a knowable, calculable and administrable object” (2008, p. 30).

The authority attributed to numbers is driven from two key aspects: our sense of their accuracy or validity as representations of some part of the world, and in their long and evolving associations with rationality and objectivity (Espeland & Stevens, 2008). The same way in which numbers achieve political salience, their seemingly objective nature, has meant they simultaneously depoliticize decision-making processes. Similar to new-constitutionalism, numbers redraw the boundary between politics and objectivity by purporting to act as automatic technical, apolitical mechanisms for making judgements. The ability to draw the line between fact and opinion has meant numbers wield unmistakable power in modern political life (Rose, 1991).

Key to the power and objectivity granted to numbers is the modern notion of risk and its juxtaposition with uncertainty. Risk is not a prediscursive entity, but a human invention that lies at the heart of modern forms of governance. Risk is a mentality of governing, one which has at its center a belief in the power to “interpret the problem of control through the quantification and the manipulation of numbers”

(Deuchars, 2004, p. 36). As Dean describes it:

Risk is a way – or rather, a set of different ways – of ordering reality, of rendering it into a calculable form. It is a way of representing events so they might be made governable in particular ways, with particular techniques, and for particular goals. It is a component of diverse forms of calculative rationality for governing the conduct of individuals, collectivities and populations. (1998, p. 25)

As the problem of uncertainty is addressed via methods of numerical calculation, what was previously the political, subjective and indeterminate domain of uncertainty is transformed into the objective entity of risk.⁴⁵ Best (2010) describes risk as a way of conceptualizing indeterminacy that makes it amenable to probabilistic calculation, thus making the world more certain, controllable and governable. The concept of risk is founded on a hubristic belief in the infallibility of rationalist-empiricist epistemology, which dismisses actual uncertainty and precludes the possibility of non-quantifiable entities. As such, the current discursive hegemony of risk within financial practice marginalizes uncertainty because it does not fit into the rationalistic, calculative idioms that dominate contemporary narratives on how the financial system operates (Deuchars, 2004). Statistics, in enabling the taming of chance, in turning a qualitative world into information and rendering it amenable to control, in establishing the classifications by which people come to think of themselves and their choices, appears to be bound up with an apparatus of domination (Hacking, 1991).

Legitimacy and Quantification

Financial risk has not always been a calculable entity. The idea that through the use of the right mathematical tools and the gathering of appropriate statistics financial risk can be calculated is distinctly modern. In *A Genealogy of Finance* de Goede (2005) ponders how modern finance has acquired the reputation of economic necessity and scientific respectability when less than two centuries ago it stood condemned as gambling and fraud. The once prominent image of financial speculators being akin to a blindfolded monkey throwing darts at stock options has been largely replaced by images of rocket scientists capable of beating the market. While financial markets have been marked by a number of crises and

⁴⁵ The dichotomy between subjective uncertainty and objective risk is established because, following economists John Maynard Keynes and Frank Knight, uncertainty is by definition not capable of probabilistic calculation.

scandals, such as Enron, Long-Term Capital Management (LTCM) and the Subprime Crisis, now the science of financial theory is rarely, if ever, questioned (de Goede, 2005). As will be discussed, the controversy previously associated with the financial profession was overcome by the application of risk-based quantitative methods to financial markets. This created a highly centralizing dynamic as numbers began to replace people in decision-making processes. The development of the professional credit rating industry mimics these wider trends.

The construction of finance as a coherent domain governed by its own internal laws was initially driven by the birth of modern statistics and their application to financial markets. The application of charts, graphs, and tables of financial market activity did not so much discover a financial reality, but transformed “diverse and contingent credit practices into a coherent and measurable financial domain with a life cycle of its own” (de Goede, 2005, p. 89). Charles Dow, and soon followed by John Moody, were the first to systematically apply the new tools of modern statistics to financial markets. In constructing the Dow Jones Average, Dow aspired to the standardization, quantification, and objectivity of financial news (de Goede, 2005). In a similar vein, Moody attempted to have financial investment shift from a guessing game based on faith, to a science based on statistically compiled information.

The taming of financial chance reached new heights with the application of advanced mathematical modelling techniques to financial markets. This was witnessed in the birth of *delta* hedging in 1967 and the Black-Scholes formula in 1973. *Delta* hedging is an arbitrage-based trading strategy developed by Edward Thorp and Sheen Kassouf in their 1967 book *Beat the Market*. While this type of trading had been done before, Thorp and Kassouf were the first to develop and systematically apply a quantitative method for undertaking such trades. This system, they argued, was a scientifically proven formula that allowed traders to beat the market. Over time, every Wall Street bank and most hedge funds would practice this type of arbitrage strategy (Patterson, 2010, pp. 36-38). The culmination of quantitative-based trading lies in the use of algorithm-based high-frequency trading, which now accounts for over 60% of all daily transactions on the US stock market (Bowley, 2011).

Following the work of Thorp and Kassouf, Fischer Black and Myron Scholes, both economists at the University of Chicago, came to produce what was most likely the “the most famous paper in the history of finance” (Patterson, 2010, p. 39). Due to its revolutionary nature, their 1973 paper, “The Pricing of Options and Corporate Liabilities”, was initially shunned from prominent economic journals and published in the *Journal of Political Economy*. By the mid 1980s however, the Black-Scholes formula came into widespread use in the trading pits of the Chicago financial derivatives exchange, and not long after that came to represent financial common-sense, a formula which graduates are now expected to know. As Scott Patterson describes, the formula was “destined to revolutionize Wall Street and usher in a wave of quant’s who would change the way the financial system worked forever” (Patterson, 2010, p. 39). What was once run by an old-boy network trading on instinct has now been taken over by new players who, typically having PhDs in a numerate discipline, trade off the numbers (Wilmott, 2000). The once rigid boundary between traders and programmers, which meant programmers were not allowed to trade, has been steadily dissolved as trading has become more computerized and quantitative.

Both the Black-Scholes formula and the *delta*-hedging strategy drastically altered how people viewed financial markets. Black Scholes was said to represent the birth of the modern practice of calculating financial risk. It was heralded as the “scientific discovery of financial truth” (de Goede, 2005, p. 131) and described as producing “risk-free profit” (MacKenzie, 2006, p. 8). The Black-Scholes formula countered the perception of financial speculation as gambling, which had surfaced in the wake of the 1929 Wall Street crash (MacKenzie, 2005). The formula legitimized derivatives trading – which would later come to occupy a huge segment of global financial transactions – by depicting it as a technical matter governed by certain mathematical laws.⁴⁶ The formula removed the subjective and uncertain components that existed in previous equations thereby allowing financial risk to become reified as a calculable entity.

The result of this process is the faith now commonly placed in methods of financial risk calculation.

⁴⁶ Derivatives are financial products whose price depends on the underlying price of another market product, such as a commodity or price index. They are used for either hedging against certain price movements (i.e., risk management), or speculation. Their use was traditionally deemed a form of gambling and was thus illegal in a number of countries. Following the liberalization of financial markets and the widespread adoption of the Black-Scholes formula their use was legalized in most developed countries and subsequently grew rapidly. In 2000 the amount of cross-border derivatives trade stood at US\$8 trillion; by 2001 that figure reached US\$168 trillion (Sassen, 2005).

Modern finance has acquired a logic of calculability and an appearance of scientific objectivity that “places its fundamental assumptions – such as indicators of performance – beyond discussion and debate” (de Goede, 2004, p. 3). The authority of such performance indicators is not based on rational forces of scientific progress, but a social *belief* in their accuracy. As Deuchars notes, “Risk is the deity that we now prefer over Fortuna. It is an act of faith to believe in risk just as much as it is to believe in fate” (2004, p. 97).

Mathematical risk calculation techniques, combined with the now staggering power of computers, tend to incite an artificial comfort in the accuracy of their predictions. As financial historian Peter Bernstein comments: “Nothing is more soothing or more persuasive than the computer screen, with its imposing arrays of numbers, glowing colours, and elegantly structured graphs”; yet, we tend to forget that computers only answer questions, they do not ask them: “Whenever we forget this truth and live by the numbers, the computer has simply replaced the oracles to whom people resorted in ancient times” (Bernstein, 1996, p. 336).

Part 3: The Science of Credit Rating

Risk, previously defined as means to make indeterminacy amenable to probabilistic calculation, is a key component to how rating agencies construct an objective domain of credit risk. In reducing a large volume of uneven and mixed format information about a firm down to a simple credit rating, CRAs inadvertently enact the first part of Knight’s famous analysis of the difference between uncertainty and risk (Carruthers, 2013). CRAs did not discover a scientific formula for the calculation of creditworthiness, they invented one; they created a common language of risk – the idea that creditworthiness was a calculable entity – that previously had no counterpart and now acts as a base-line reality in financial markets (Abdelal, 2007). Utilizing the tools of modern statistics, this language of risk transformed diverse and contingent credit practices into a coherent and measurable financial domain of creditworthiness (de Goede, 2005). This mental framework, similar to what Sinclair has termed the “mental framework of rationalist rating orthodoxy” (2005, p. 69), is built on the notion that creditworthiness can be measured objectively by experts and then expressed in a simple alphanumerical form.

When the concept of risk is applied to financial risk analysis the possibility of credit default is no

longer an opaque and indeterminate possibility, but a visible and calculable entity. The rating agencies construct an authoritative framework of financial knowledge that supports the belief that it is possible to measure, dissect, and thereby *manage* risk (Velthuis, 2012). From the outset, ratings were understood to offer more than just a compilation of existing information, but rather “scientific deductions drawn from that information” (Carruthers, 2013, p. 13). The agencies’ classification system transformed indeterminate uncertainties into calculable risk. This was established through the creation of a standardized ordinal category system into which all debt is classified. Through the reiteration of fiscal relations and financial products as inherently commensurable, credit ratings performatively construct an objective entity of financial risk.

The continuous effort to make analysis more quantitative is seen in the sovereign rating process. The Rating Analysis Methodology Profile (RAMP) is an example of the deliberate discounting of uncertainty-based measures in favor of a quantifiable risk calculus. RAMP is used by S&P to categorize sovereign credit analysis into five key quantitatively weighted variables rated on a scale from one to six.⁴⁷ While CRAs claim not to design ratings as a probabilistically quantifiable frequency, there are nonetheless consistent attempts to frame key qualitative and inherently subjective indicators, such as the stability and legitimacy of a political institution, into absolute risk terms. The purpose is to “translate more uncertain (political) events into statistical regularities” (Paudyn, 2012, p. 8). The dynamism and fluidity that once characterized sovereign fiscal relations appears to “be transformed into objective knowledge as the calculation of an indeterminate fiscal future is purported to become tractable to defensible risk management” (Paudyn, 2012, p. 11).

The idea that CRAs are able to objectively evaluate a sovereign’s creditworthiness marginalizes alternative notions of budgetary normality. As Hacking (1991) notes, by enabling the taming of chance statistics is bound up with the apparatus of domination. As alternatives to quantitative risk calculus are invalidated, so are competing versions of fiscal normality. The idea that quantitative econometric data is sufficient to calculate levels of creditworthiness reinforces the diminished importance of non-economic and

⁴⁷ This includes: political score; economic score; external score; fiscal score; and monetary score (in Paudyn, 2012).

non-financial ways of thinking (Sinclair, 2001). Paudyn picks up this point: “The hegemony of risk in the constitution of sovereign creditworthiness invalidates how competing notions of budgetary normality are ascertained and articulated, such as by politicians or civil society” (2012, p. 4). By creating and objectifying a seemingly neutral standard of creditworthiness CRAs cement an overly marketized and economistic idea of creditworthiness into the architecture of global finance.

The current legitimacy given to credit ratings and financial risk management techniques more broadly is driven by their ability to provide security in the face of an uncertain future (de Goede, 2005). It is the perceived ability of rating agencies to transform future uncertainty into a quantifiable measure of risk that formed the basis for their elevation to key pillars of the financial system. The rating agencies do not so much provide new information to the market – as they have often been criticized for lagging the market – but they create order and coherence in an otherwise chaotic world of global finance. As Paudyn (2012) argues, the authority of credit ratings is derived from their ability to divorce their techno-scientific epistemology from its messy political-economic content; this is achieved by the application of risk-based quantitative methods.

Tellingly, Flandreau, Gaillard and Packer (2011) argue that it was not the superior predictive power of the rating agencies that led to their development in the mid-20th century, as credit ratings were widely used in the marketplace long before anyone knew precisely how useful the ratings were. In 1936 credit ratings began to be used by the Comptroller of the Currency in the US to regulate the investment practices of banks. Yet, it was not until 1938 that Gilbert Harold’s PhD thesis first tested the accuracy and usefulness of credit ratings using a small sample size. The first major collaborative study did not emerge until the 1950s. This is significant because “for some time after becoming a familiar device for mitigation of uncertainty, ratings were of unknown value and could only offer the appearance of quantitative rigor” (Carruthers, 2013, p. 16).

Credit ratings are no exception to the control illusion incited by the use of advanced mathematics (Colander et al., 2009). This is why in the lead up to the Subprime Crisis, as a credit analyst put it, “everyone

assumed the credit rating agencies knew what they were doing” (in Lowenstein, 2008). Part of the reason for this, was the way in which their analysis is dominated by advanced mathematics and quantitative methods: “The very possibility of fallibility seemed to be discounted because of the way the entire rating process was enshrouded with images of ‘rocket science’ and quantitatively rigorous analytical methods” (Carruthers, 2010, p. 166). Velthuis, in a similar vein, points out: “The technical, calculative nature of the language employed by the rating agencies [conceals] the profoundly inter-subjective, contingent and political manner in which knowledge about financial markets is constructed” (2010, p. 18).

The rating agencies often use the perceived objectivity of their analysis to their advantage. When criticized or asked to justify a decision CRAs often use the objectifying cloak of quantitative economic and financial analysis to avoid further contention, essentially “hiding behind the numbers” (Sinclair, 2005, p. 34). The downgrading of Detroit is an example where despite the clear presence of political factors, following criticism Moody’s claimed that the report was “based on the kinds of objective numbers the agencies had always used to provide information to investors” (in Sinclair, 2005, pp. 34-35). The press statements released by the rating agencies, along with the ratings themselves, effectively downplay the subjective nature of their judgements and how unquantifiable socio-political data informs their decisions (Whiteside, 2006; Sinclair, 2001). Because their press releases do not publicize the subjectivity involved in their ratings, they foster, Sinclair argues, a “popular myth that ratings...reflect simply the facts revealed by economic and financial analysis” (Sinclair, 2005, p. 84). This gives rise to a myth that any person with all the facts and technical know-how would rationally come to the same conclusion.

Theodore Porter’s (1995) concept of *mechanical objectivity* is useful to highlight how standardization, objectivity and quantification can be imposed on, rather than sought by, certain professions. Mechanical objectivity establishes legitimacy through the use of seemingly objective quantitative methods that constrain the local, subjective and personal elements from decision-making. One of the enduring appeals of the quantitative method is the *idea* that it facilitates the production of knowledge that transcends particularities of place, language, and custom (Espeland & Stevens, 2008). Pressures for mechanical objectivity arise when decisions are subject to public scrutiny, especially from

powerful outsiders, and when experts are distrusted (Espeland & Vannebo, 2007, p. 25). Porter (1995) draws from the development of the actuarial and accounting practices in Britain and France as examples.

These conditions clearly apply to CRAs' judgements, which are often subject to criticism from powerful outsiders as a result of their perceived failures. Mechanical objectivity is often used by weak elites who cannot adequately defend their authority via alternative methods. Under such conditions, trust in CRAs is essentially replaced by a trust in numbers. The shift from the personal expertise of the CRAs to the reliance on objective principles of calculation is currently underway and is being resisted by the rating agencies. As Moody's states, "Any attempt to reduce credit rating to a formulaic methodology would be misleading and would lead to serious mistakes" (Moody's, 2013). Following the Asian financial crisis regulators discussed methodological standardization. A survey of agencies found that most respondents believe that proposals for harmonization or standardization are based on a misconception as to what ratings are and what they measure. They are not and do not seek to be objective homogeneous products. Standardization, even if achievable, would erode much of the value of ratings and be in itself misleading (Rona-Tas & Hiss, 2010).

Standardization and quantification generate a centralizing dynamic in decision-making processes. The quantitative revolution in retail banking illustrates a more advanced form of this dynamic. Incorporating recent technological developments, retail banks have downgraded the intuitive knowledge of local managers, placing greater emphasis on the systematic use of quantifiable data on consumers in order to determine creditworthiness (Leyshon & Thrift, 1999).⁴⁸ The embodiment of this process is the widespread use of credit-scoring techniques in which lenders numerically weigh an individual's creditworthiness by using a limited set of variables, most of which are related to the individual's income. The practice of credit scoring serves to homogenize borrowers, who are differentiated only by their FICO score. Credit scoring has "render[ed] individual borrowers into units of homogeneous distribution with well defined parameters" (Lapavistas, 2007, p. 419). This transformation allowed for the standardization of lending decisions, shifting

⁴⁸ Face-to-face banking, in which bank managers would access various financial, social and cultural criteria to determine a person's creditworthiness is declining as illustrated in the decline of bank branches. Between 1989 and 1995 the number of banks declined in Britain by 19% (Leyshon & Thrift, 1999).

power away from branches and towards the center of the firm (Leyshon & Thrift, 1999). While the credit rating process has not reached the same degree of standardization, the perception of CRAs' methodological standardization is pervasive, although not complete. The use of risk-based quantitative methods creates a centralizing and mechanistic dynamic within decision-making processes as numbers, due to their association with objectivity, begins to replace the people in decision-making processes.

Conclusion

This discussion on the governance function now played by numbers illustrates a few key points. The application of quantitative methodologies to financial markets has particular transformative capacities. Measurement tools, as Callon has argued, "do not merely record a reality independent of themselves; they contribute powerfully to shaping...the reality that they measure" (in de Goede, 2005, p. 118). A particular dimension to this transformative capacity is its ability to generate the perception that such techniques are able to tame ambiguity and objectively determine financial risk, or creditworthiness. This creates a centralizing dynamic as numbers replace people in decision-making processes. While credit ratings are not numbers (although some contain a numerical component), the quantitative and objective measurements that are seen to underpin them contribute to a similar dynamic as witnessed in more advanced cases of methodological standardization.

Chapter 6: Uncertainty Absorption

To the enlightenment, that which does not reduce to numbers, and ultimately to one, becomes illusion; modern positivism writes it off as literature. (Adorno & Horkheimer, 1997, p. 7)

Peter Miller (2001) has argued that the calculative practices of accounting have one defining feature that sets them apart from other forms of quantification: their ability to translate diverse and complex processes into a single financial figure. It is with the elegance of the single figure that the objectivity and neutrality widely accorded to numbers achieves its most developed form (Porter, 1995). The single figure is set apart from disputes and political interests, and endowed with a legitimacy that seems difficult to contest or dispute (Miller, 2001). This new infallibility granted to such figures is producing the “contemporary tyranny of the single performance measure” (Amernic & Craig, 2009, p. 177). The goal to produce such figures is described by Hans Morgenthau (1947) as a constant search for the philosophers’ stone, a formula that substitutes the certitude of rational calculation for the uncertainties and risks of political life. Yet, as Morgenthau astutely observes, since political life is complicated, irrational and incalculable, in searching for such scientific solutions these seekers are compelled to simplify politics and rob it of its inherent indeterminacy (1947, p. 86). Herein is the significance of the single figure—its ability to absorb uncertainty.

This chapter will first explore how the form of a credit rating contributes to the process of uncertainty absorption and how this is related to the influence of credit ratings. Next, it is argued that the form of the credit rating creates a situation where those using the rating are not able to evaluate either the credit rating or the method used to generate it. Reinforcing the previous chapter’s focus on the embeddedness of markets, the following section will discuss the role that belief played in the Subprime Crisis in general and the use of credit ratings in particular. The point is to shift attention away from hegemonic behavioral assumptions, particularly the rational actor models that dominate contemporary accounts of market behavior. Finally, as a prelude to the final two chapters, the way in which the US state was able to discursively respond to the Subprime Crisis and reinforce pre-existing market structures and power-relations is noted.

Part 1: The World's Shortest Editorial

Uncertainty absorption occurs when an inference is drawn from a body of evidence and the inference instead of the evidence is communicated (March & Simon, 1993). Carruthers and Espeland explain the dynamic of uncertainty absorption occurring within the modern practice of double entry bookkeeping:

...[It] edits and frames information...extraneous detail can be identified and eliminated. Qualitative differences can be reduced to quantitative differences...The complexity of economic reality is reduced, and decision makers are presented with a simple 'bottom line', one that does not reflect all possible interpretations and judgements. (1991, p. 57)

The single figure, as Carruthers and Espeland (1991) explain, gains its significance through the process of uncertainty absorption: a process in which complexity is replaced with simplicity, subjective uncertainty with objective risk, and decisions shift from being political debates to mechanistic processes dictated by technical criteria. The authority of the single figure, and its associated process of uncertainty absorption, is central to the power of credit ratings. As raw information is collected and compiled, it is manipulated, edited and eventually transformed in order to make it more accessible to a wider audience. This editing process removes assumptions, discretion and ambiguity from the decision-making process. The outcome is that the information communicated appears more robust and objective than it actually is (Espeland & Stevens 2008, p. 422).

Credit ratings are derived from a large amount of data, subjective opinion and committee deliberation. The result of this process is a single grade, like AAA or BB1, which is meant to capture the creditworthiness of a debt issuer or product in its entirety. Ratings are thus a particularly good example of uncertainty absorption. Carruthers comments on credit rating in the early 20th century: "Ratings were derived from the messy ledger information, but because they involved placement into a clear set of ordinal categories, they appeared systemic, precise and well-ordered" (2013, p. 8). The significance of the credit rating (i.e., AAA) itself has been largely neglected in academic and public policy circles. The focus has consistently remained on the Big Three CRAs themselves. The issue was briefly mentioned in the 2012 Public Hearing on Credit Rating Agencies held by the European Committee on Economic and Monetary

Affairs. In his testimony to the committee, Mr. Philipponnat (2012), the Secretary General of Finance Watch, argued that the “single most important measure” for reducing over-reliance on ratings is to “change the form under which credit ratings are expressed.” If credit ratings are to be considered financial opinions, Mr. Philipponnat argued, they should be expressed as such; ratings, however, are not expressed as opinions, but facts, seemingly objective indicators of performance.

A defining feature of credit ratings is therefore their ability to capture the complexity of creditworthiness into a single measure of worth. As a Fitch spokesperson puts it, “we provide the world’s shortest editorial” (Osborne, 2012). The ability to perceive a complex world through a set of comparative and simple symbols is precisely what rating agencies sell to investors (Bruner & Abdelal, 2005). As Leo O’Neill, former President of S&P, notes, “What makes our ratings such a strong factor in the market is that they take into account all the factors that surround a debt obligation and reduce it to a letter symbol which is easily understood” (in Sinclair, 2005, p. 40). Uncertainty absorption has indeed been central to the historical evolution of the rating business. Charting the development of the credit rating industry over the last two hundred years, Hartmut Berghoff (2008) describes the reduction of complexity as its defining feature. The detailed accounts of credit history and personal proclivities that characterized the reports of the 1850s were, by the 1870s, replaced by summary reports, and by 1909, “three letters suffice to give a risk assessment” (2008, p. 22).

The form of credit ratings coincides with the now socially valorized aesthetic ideals of clarity and parsimony (Espeland & Stevens, 2008, p. 426). Its simplicity is undoubtedly the root of its attractiveness as a regulatory tool (Bruner & Abdelal, 2005) and the main reason ratings are consistently referenced in media reports. Their simplicity is also a driving factor behind their use in financial contracts: in a contract between a layperson and a broker, it is easy for a person with little understanding of finance to set decision-making guidelines for those managing their money. Simplicity and useability are defining features of our current financial risk management strategies. As Millo and MacKenzie argue, “The remarkable success of today’s financial risk management methods should be attributed primarily to their communicative and organizational usefulness and less to the accuracy of the results they produce” (2009, p. 638).

By absorbing residual uncertainty credit ratings remove or obscure the responsibility of investors, issuers and public regulators to manage their own uncertainty. Paudyn describes credit ratings as an “inexpensive form of outsourced due diligence” (2012, p. 13; 16). This dynamic became readily apparent during the securitization process in the US. As Bruner and Abdelal note, the rating agencies became “a repository for the residual uncertainty associated with credit risk...permitting semi-wilful ignorance of the full measure of uncertainty inherent in investment” (2005, pp. 210-211). Much like a seat belt, the very existence of credit ratings increases investors’ risk appetite.

Similar dynamics of risk absorptions can be seen in the growth of auditing, producing so-called empty comfort certificates, and Value-at-Risk (VaR) models. Power (1997) describes the audit explosion as a distinct response to the need to process and quantify risk. This, however, he considers a distinctly cosmetic practice that hides real risk and replaces it with the financial risk faced by the auditors themselves. Where the audit process is defensively legalized “there is a risk of relying too heavily on an industry of empty comfort certificates” (Power, 1997 p. 123). Similarly, the appeal of VaR models is described in similar terms. VaR models measure the boundaries of risk in a given portfolio over short durations of time. VaR became a popular risk management tool as it took a head-spinning variety of variables, including diversification, leverage and volatility, and then transformed them into a single figure that expresses risk (Nocera, 2009). As *New York Times* journalist Joe Nocera (2009) comments, “VaR’s great appeal, and its great selling point to people who do not happen to be quants, is that it expresses risk as a single number, a dollar figure, no less.”

As a direct result of their ability to absorb uncertainty, credit ratings simultaneously convey and omit information; “when you’re in a symbol system”, as McGuire, a former VP at Moody’s, argues, “you inherently suppress some information” (in Sinclair, 2005, p. 40). The sheer simplicity of the ratings – along with the accompanying downgrades, upgrades, negative watches and positive outlooks – obscures the vast complexity of the ratings process and the inherently subjective nature of credit assessment. As Charles Goodhart (2009) argues, recipients of credit ratings tend to focus unduly on the inference while ignoring the wider probability distribution—that is, the uncertainty. This is encouraged by the emphasis placed on the

particular rating as opposed to the probability distribution of implied credit default (Goodhart, 2009).⁴⁹

John Grout, the Policy Director for the Association of Corporate Treasurers in the UK, argued in the House of Commons that the trouble with the headline rating is “that it is plain, simple and easy...it appears to mean the same thing between different rating agencies, but actually it means different things”; the temptation to “just follow the letter rating, rather than read the report and think what they mean...that’s where you get the problem” (UK Parliament, 2012). This is not the consequence of ignorance or laziness on behalf of market participants, but is actively encouraged by the symbol system. As Abdelal and Bruner argue, for agencies to criticize investors for accepting the rating symbol as an absolute value and applying it as an investment criterion without questioning the rationale is perhaps hypocritical when “the very selling point of the letter-grade system is the economy of thought it invites” (2005, p. 210).

According to the rating agencies, a specific appeal of credit ratings is that they are comparable across all debt categories. Sovereign bonds, corporate securities and structured finance products are all classified within the same rating scale. As Standard and Poor’s states, “Our ratings represent a uniform measure of credit quality globally and across all types of debt instruments” (in Priebe, 2012, p. 96). The way in which they achieve this is through the process of commensuration, which “transforms qualities into quantities, differences into magnitudes...It is a way to reduce and simplify disparate information into numbers that can easily be compared” (Espeland & Stevens, 1998, p. 316). Credit ratings therefore enable the simplifying, classifying, comparing, and evaluating of all forms of financial products and their risk.

By creating a scale of ratings that includes the plethora of credit instruments from sovereign bonds to structured financial products, credit ratings promote the belief that the differences between such products are purely quantitative. Classifying all financial instruments under a “single panoptic schema” masks important heterogeneity within investments, and has encouraged investors to treat financial options as equivalent simply because they were put in the same category (Carruthers, 2010, p. 172).

⁴⁹ In recognizing the need to promote uncertainty in the use of credit ratings, Goodhart argues that CRAs should provide additional information on the “prospective confidence limits (volatility) of their forecasts [in order to] expose their uncertainty” (2009, pp. 173-176). The way in which this could be achieved is through the supplementary use of fan charts. The rating agencies have made no such effort to expose the uncertainty or confidence limits of their ratings.

Diverse and distinct domains of economic and financial activity are simultaneously unified under a common standard of creditworthiness and differentiated with regard to their ability to live up to that standard. The process of commensuration creates a centralizing dynamic as those producing the standards at the center come to dominate those in the periphery. As Miller and Rose argue, “domination involves the exercise of a form of intellectual mastery made possible by those at a centre having information about persons and events distant from them” (2008, p. 34). This process involves not only the gathering of information, but also the privileging of a type of knowledge held by those at the center, while simultaneously diminishing the importance of local, subjective or counter-hegemonic knowledge. Within the process of commensuration, “everyday experience, practical reasoning, and empathetic identification become increasingly irrelevant bases for judgment as context is stripped away and relationships become more abstractly represented by numbers” (Espeland & Stevens, 1998, p. 317). In this way, commensuration reconstructs pre-existing relations of authority by privileging numbers, and those who produce them, as opposed to alternative forms of knowledge surrounding creditworthiness.

The problem of perceived equivalence was illustrated when increasingly complex collateralized debt obligations (CDOs) began entering the US secondary mortgage market in the late 1990s. Because the same category was being used to classify these new complex CDOs as had been applied for decades to ordinary and relatively stable corporate bonds, the effect was to “domesticate the exoticism and mystery that CDOs would have otherwise possessed” (Carruthers, 2010, p. 164). Without the perceived comparability these CDOs would have been viewed with much more suspicion and greater diligence would have been used to evaluate their associated risk. As the World Bank noted, “Because many institutional investors and even banks viewed debt with the same credit rating as fungible, even the most complex, innovative or opaque debt instruments could be sold as long as it received an investment-grade rating” (in Priebe, 2012, p. 11).

The form of the credit rating also creates a situation in which market participants are not able to evaluate the credit rating or the method used to generate it. Both the information on how the rating was generated and the data used within the determination process are unavailable to the public. Even the

commentary accompanying a rating change is generally unavailable to the public due to its high costs.

When a communication contains only an inference and removes the data, processes, and ambiguity of its construction, it hinders the ability of observers to purposefully critique the implied inference.

Through the process of uncertainty absorption the recipient of a communication is severely limited in his ability to judge its correctness. Although there may be various tests of apparent validity, internal consistency, and consistency with other communications, the recipient must, by and large, repose his confidence in the editing process that has taken place, and, if he accepts the communication at all, accept it pretty much as it stands. (March & Simon, 1993, p. 186)

A large part of the agencies' credit analysis draws from private and confidential information from consultative meetings with the issuer; this includes budgets, forecast and financial statements. Structured financial products, RMBS for example, offer little transparency around the composition and characteristics of the underlying loan collateral (Fons, 2008).⁵⁰ Next to confidential information, the analytical process for determining a credit rating judgement is the most secretive aspect of credit rating (Sinclair, 2005). Actual committee discussion remains the invisible ingredient or black box in the ratings process (Bruner & Abdelal, 2005). The reason the rating agencies are not more forthright about publicizing the content of committee discussion is that it is the most clearly subjective component of the credit rating process. S&P describes the committee processes in sovereign credit rating as moving beyond "a strictly formulaic assessment" in an effort to "factor into its ratings the perceptions and insights of its analysts" (S&P, 2012, p. 7). Because of the subjective elements involved, this factor of the rating determination process is not, and cannot be, displayed on the methodological outlines disclosed on the agencies' websites.

Following the Subprime Crisis governmental agencies tasked with regulating financial markets, specifically the SEC and ESMA, undertook a concerted effort not only to regulate the conflict of interest embedded in the agencies' business model, but to also reduce over-reliance on credit ratings. Transparency was promoted as the best means to achieve this. The belief was that if market participants better understood the rationale behind the rating process they could potentially disagree with their judgments. As Christopher Cox (2008), the Chairman of the SEC, argued in 2008 following the passing of regulations

⁵⁰ As Jerome Fons (2008), a VP at Kroll Bond Rating, testified to the Committee on Oversight and Reform, "Potential investors are not privy to the information that would allow them to understand clearly the quality of the loan pool."

governing CRAs, “The rules proposed today are designed to improve investor understanding of credit ratings through enhanced disclosure of NRSRO methods and performance.” Even in 2003 the SEC argued that in order to reduce over-reliance on credit ratings, “the marketplace needs to more fully understand the reasoning behind a ratings decision and the types of information relied upon by the rating agencies in their analysis” (Nazareth, 2003).

The opaque nature of the ratings process is not due solely to undisclosed information. The sheer complexity of the financial products being rated is also a contributing factor. Regardless of the availability of information, the complex mathematical formulae underpinning these products are far beyond the ability of the average economist to comprehend; hence why financial institutions have begun employing specialist mathematicians and physicists to keep pace with such development (Nesvetailova & Palan, 2010, p. 805). In criticizing the SEC’s disclosure paradigm, Henry Hu (2012) argues that innovation in financial theory and practice has meant that some information has become “too complex to depict” (2012, p. 1601): “Financial innovation has proceeded to the point where important structured financial products are so complex that they are inherently non-transparent” (in Priebe, 2012, p. 82) The complexity of the mathematics being used has even inhibited the upper management of banks from understanding and exercising judgment about the various risks being taken (Turner Review, 2009, p. 22). If the upper management of banks is unable to understand such complex modelling, how would an increase in transparency within the ratings determination process aid everyday investors in performing due diligence?

Picking up on this point, Deuchars (2004) argues that such technical knowledge has redrawn the boundaries between experts and laypeople; it has created a new division of labor between those who do and do not have a particular kind of knowledge. The increasing sophistication of modern finance has led to the construction of a new type of governance, one “based on the acceptance of the superiority of a kind of knowledge that derives from mathematical methods and numerical manipulation and that is presented in such a way that skill is required for its meaningful interpretation, a skill that most people have not been taught” (Deuchars, 2004, p. 77). This knowledge is accorded superiority and an unquestioned status. It is not simply technical experts who have become key focal points of governance. Rather, a particular kind of

knowledge, one related to complex mathematical models and risk calculation techniques, has emerged to play a key role in contemporary governance.

Part 2: They, too, Drank the Kool-Aid

Despite assertions to the contrary, this section will argue that an intersubjective belief in the rocket science of modern finance played a crucial role in the development of the Subprime Crisis and the perceived objectivity of credit ratings. Dominant narratives of behavior in financial markets routinely neglect the causal significance of social beliefs; market actors are seen as being driven solely by calculative and rational greed and whose interests are formed prior to social interactions. This is a trend prevalent within the IPE itself, which has been dominated by rationalist-materialist approaches in which scholars treat any outcome as a result of a struggle among utility-maximizing actors whose interests can be unproblematically specified from material structures (Chwieroth & Sinclair, 2012, p. 1). By exploring the build-up to the Subprime Crisis, this section illustrates the role of belief in financial markets in general and in credit ratings in particular.

One of the remarkable things about financial crises is that they often give rise to a political process with uncanny similarities to a witch-hunt. Because of the understandable desire to assign blame following such a calamity, it is easy to adopt -- all too simplistically -- an amoral calculator hypothesis (Sinclair, 2010; MacKenzie, 2011) and an exogenous approach to financial crisis.⁵¹ The conflict of interest embedded in the issuer-pay business model, and the ways in which this is exacerbated, means that the rating agencies are often described as misleading investors with regard to the real risk involved in a number of complex financial products.⁵² Such fraudulent behavior is then linked to the 10,000 or so AAA-rated securities that defaulted, which were described as a key cause of the financial collapse. While a number of commentators have highlighted the conflict of interest embedded in the issuer-pay business model, very few have asked: what is the impact of the widespread focus on the rating agencies' conflict of interest? This section will

⁵¹ An exogenous approach to financial crisis places the blame of financial collapse on various causes that remain *external* to the normal operations of markets.

⁵² Some include: the drive towards increasing market share; the increasingly competitive nature of the rating industry, and the pressure from large investment banks to inflate ratings (Mullard, 2012).

argue that the focus on the agencies' conflict of interest obscures from view more systemic problems embedded within neoliberal globalization and the subjective nature of the credit rating process.

In order to demonstrate the existence of a belief in the rating process, and contemporary financial risk management techniques more generally, it is necessary to move away from the hegemonic depictions of financial market participants as being driven solely by rational and calculative greed. The most specific manifestation of this belief is the view that the CRAs, motivated by financial gain, deliberately failed to accurately assess the risk of various subprime-backed securities. This view not only adopts a neoclassical rational actor model, but also reinforces the belief that financial risk can be objectively determined. While conflict of interest clearly manifested itself in the business of the rating agencies – as illustrated in the detailed investigations conducted by the Financial Crisis Inquiry Commission (2011) and the US Permanent Subcommittee (2011, pp. 272-288) – we must ask whether this was the primary determining factor in the systemic mispricing of credit risk in the lead up to the Subprime Crisis? The argument here is that the issuer-pay model cannot be considered the primary cause of misleading ratings. The issuer-pay business model was introduced in the 1970s; spectacularly inaccurate ratings however, did not emerge until the early 2000s. Thus, although perhaps necessary, perverse incentive explanations are insufficient (Fligstein & Goldstein 2010, p. 59).

Given the subprime market was worth only \$0.7 trillion out of the total global capital market's \$175 trillion, the subprime delinquencies could not have bankrupted the global financial system. The subprime market is in fact a small component of the residential mortgage sector and accounts for roughly 4% of US total assets. Moreover, the exposure to the subprime sector is small relative to the capital held by the financial institutions themselves. Any defaults by subprime borrowers could have easily been absorbed by the total capital of the financial sector (Adrian & Shin, 2008). Contagion mechanisms in the Subprime Financial Crisis could not have worked only through defaults igniting a domino effect as total losses in subprime loans amounted to only \$400 billion; if the domino effect of financial contagion were the only relevant factor then defaults on subprime mortgages would have had limited impact (Adrian & Shin, 2008, p. 2).

So how do we explain the severity of the Subprime Crisis? The paralysis that came over the global financial system from 2007-2009 resulted from a loss of faith in financial innovation (Sinclair, 2010). What was previously calculable financial risk became incalculable uncertainty. As the ratings of subprime-backed CDOs began to drastically fall in mid-2007, a cascade of doubt swept through the financial markets. The rating agencies' classification system enabled the transmission of scepticism throughout the entire financial system: if one AAA product failed, how would an A1 fair? (Carruthers, 2010). The essence of the Subprime Crisis is not illegality, or even bankruptcy of the working poor, but uncertainty about financial engineering that lay at the heart of the financial system (Sinclair, 2010). Recognizing the social nature of financial markets allows us to make intelligible the discrepancy between the limited magnitude of the initial subprime losses and the enormity of the crisis that ensued.

An arguably more compelling factor leading to CRAs' failure is, as Claire Hill argues, they too "drank the Kool-Aid": the rating agencies, along with a number of other financial actors, convinced themselves that the highly complex transaction structures that they were rating could, in fact, do what they purported to do (2009, p. 586). Given that, as Sinclair (2010) and Carruthers (2010) argue, the Subprime Crisis was driven by a loss of faith in complex financial engineering, the lead up to the crisis can be explained by a general belief in the accuracy of financial engineering and risk calculation techniques. While greed played a part in the widespread use of these practices, this does not preclude the role of belief. The apparent dichotomy between the two is misleading. All knowledge of the international political economy is "context-bound" and emerges either consciously or unconsciously in the service of particular interests (Tooze, 2000, p. 2). To further illustrate the role of belief in financial markets, the case of mortgage securitization will be analyzed.

Conventional accounts of mortgage securitization in the US describe how investment banks originated, packaged, and distributed subprime-backed mortgage securities (MBS). As banks' income was at the time increasingly fee-driven and they were aware of the underlying risk associated with such securities, the banks never held onto these risky financial products. Thus, investment banks knowingly originated poor quality securities and then sold them onto helpless investors who relied on the credit ratings.

Contrary to this narrative, every large originator and packager of mortgage securities held onto, and indeed purchased, a substantial number of MBS (Hill, 2011). From 2002 to 2008, when the supply of subprime mortgages increased most rapidly, commercial banks increased their holdings of MBS from over \$650 billion to \$1.1 trillion (Fligstein & Goldstein, 2010). Because these banks held onto a large portion of these securities they suffered significant losses as their value plummeted through 2007-2008, totalling roughly \$175 billion. This poses a significant challenge to prevailing rational-actor models that attribute the build-up of systemic risk to the perverse incentives of investment banks. The fact that they retained such a significant portion of the assets casts doubt on the notion that the crisis occurred because intermediaries strategically sold off all the riskiest assets to unwitting investors (Fligstein & Goldstein, 2010). This provides evidence that they “believed in the quality of the securities” (Hill, 2011, p. 57), or that they “believed they could control the amount of risk they held” (Fligstein & Goldstein, 2010, p. 32).

Investors’ over-reliance on credit ratings is another factor widely believed to have contributed to the build-up of systemic risk (Partnoy, 2009). The rating agencies singlehandedly misled banks and other investors into buying risky financial products. As the FCIC concluded, “Major firms and investors blindly relied on credit rating agencies as their arbiters of risk” (2011, p. xvii). While for smaller and medium-sized firms this may be a fair assessment, the idea that major investment banks and hedge funds blindly relied on the judgements of the CRAs is questionable at best. This idea is based on a misconception as to who such investors were. Complex financial instruments were not being bought by widows and orphans (i.e. small retail investors) who might have otherwise unquestioningly relied on the rating agencies; rather, they were for the most part sold to large institutional investors (Hill, 2010). These included the world’s largest investment banks, such as Goldman Sacks and JP Morgan, and the world’s wealthiest and most profitable hedge funds. All of these institutions maintain well-funded internal credit assessment divisions because, simply put, it is their job to provide investment advice.

In addition, these investors were making progressively larger bets on relatively new and risky

subprime securities.⁵³ In this context, relying solely on credit ratings would have been entirely irrational. All market participants were well informed of the recent inadequacies of the rating agencies revealed by the Asian Crisis in 1997 and the Enron debacle, among others, and they were also aware of the potential conflict of interest in the issuer-pay business model. As former Moody's analyst William Harrington (2011) said in his testimony to the SEC, "The financial institutions...mismanaged their risks entirely on their own...their treasury and risk management functions treated the same worthless opinions at full face value." As Hill puts it, "Many brilliant and sophisticated market participants with considerable amounts of money at stake and considerable access to information...made the same mistakes the rating agencies did" (Hill, 2010, p. 598).

While the rating agencies may have mispriced risk due to perverse incentives, why would commercial banks and hedge funds that actually held onto these securities make the same mistakes? It seems that there is something more systemic occurring than perverse incentives. André Orléan describes the rating agencies as bearers of valuation convention: they represent an interpretation of underlying market trends that all financial market actors agree to adopt (in Bessy & Chauvin, 2013, p. 109). This can be termed *financial rationalism*, a general belief that we have entered a brave new world of risk management due to the advances of financial engineering (Hill, 2010). Those on Wall Street have "persuaded themselves that the rocket scientists...discovered how to vastly minimize risk and maximize return" (Hill, 2011, p. 52).

The mathematization of finance incited a general belief that uncertainty had been overcome. The development of mathematical methods designed to quantify and hedge risk encouraged all major participants in financial markets, including commercial banks, investment banks and hedge funds, to use more leverage and take on more risk (Eichengreen, 2008). It appears, as Colander and colleagues argue, "as if the very use of the mathematical methods diminished the underlying risk" (2009, p. 5).⁵⁴ *The Economist*

⁵³ Investors knew that the securities were backed by mortgages to subprime borrowers; they knew that subprime mortgages had not been made in significant numbers until recently, and hence there was very little performance data available; they knew that the originators have little incentive to accurately convey risk and every incentive to overprice securities (Hill, 2010b, pp. 325-326).

⁵⁴ Colander's now highly-cited paper "The Financial Crisis and the Systemic Failure of Academic Economics", introduces a useful notion of a control illusion: a tendency for mathematical rigor and numerical precision to conceal the weaknesses of models and assumptions to those who have not developed them and thus confer an illusion of the

cites one of the architects of VaR as admitting that such risk modelling techniques led “to the illusion that you can quantify all risk and therefore regulate them” (in Best, 2010, p. 41). This has allowed it to become the basis of extreme financial risk taking and profit-making with a semblance of security (de Goede, 2004). As the *Financial Times* commented, “VaR models create a false sense of security among bank executives who do not understand what the models do” (in de Goede, 2004). The semblance of security associated with such techniques, much like that of a seat belt, encouraged excessive risk taking (Bernstein, 1996). The Turner Report listed misplaced reliance on sophisticated maths as a major contributing factor to the Subprime Crisis. Complex mathematical models provided a false comfort regarding the levels of risk involved in transactions: “Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk...could be safely ignored” (Turner Review, 2009, p. 22).

As William Davies and Linsey McGoe (2012) have pointed out, the institutions that survived the financial crisis, or even thrived, have been those able to recognize that risks were unknowable or unpredictable. Contemporary risk assessment models and valuation techniques are far too optimistic in assuming that the uncertainties of market movements and the ambiguities of valuation could be easily quantified and calculated, and thus managed (Best, 2010). Financial markets are inherently social; problems therefore emerge when finance is considered a science rather than an art. Paraphrasing George Soros, Nicholas Kiersey comments: “[The] principle fault for the crisis should...be lain squarely at the feet of modern economic theory and its misguided belief in itself as a 'science'...While the methods of natural science may be appropriate for studying the stuff of the natural world...they can produce seriously misleading results when applied to the realm of human affairs” (2011, p. 26).

Although enthusiasm for the science of securitization has waned somewhat in the context of the current crisis, just about every major financial voice has at some point in time sought to remind us all of the purported benefits of the process (Best, 2010). In 2006 the IMF stated, “There is a growing recognition that

the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on the balance sheet, has helped to make the banking and overall financial system more resilient” (IMF, 2006, p. 51). Belief in the wonders of securitization was pervasive not only in the private sector and IOs, but also in national governments. Regulators themselves played a crucial role in the creation of this market structure (Thompson, 2012).

These beliefs were reinforced by a specific organizational and cultural ethos within Wall Street. Recruited from the elite universities, workers on Wall Street are trained to view themselves as the best and brightest (Ho, 2009). Such widespread self-regard, along with a culture of elitism, set the stage for extreme forms of hubris (Carruthers, 2010) and a deeply entrenched can-do attitude. Prior to financial crises there is a consistent belief that this time is different, that “we are doing things better, we are smarter, we have learned from past mistakes” (Reinhart & Rogoff, 2009, p. 1). All significant bubbles have been periods of major innovations, giving credibility to the hypothesis that a new age has emerged in which the limitations of the past are no longer valid (Orlean, 2010). Rather than a scenario in which each actor was fleecing the next guy down the line, the account presented here is more consistent with a theoretical imagery of collective, field-wide delusion (Fligstein & Goldstein, 2010).

Following such observations, when describing why the rating agencies became AAA factories we must shift attention away from greed. Such logic does not stand up to scrutiny. Producing higher ratings than is warranted undermines effective medium and long-term business strategies.⁵⁵ Drawing from eighty-seven oral interviews with those involved in the mortgage securitization industry, Donald MacKenzie argues that amoral calculation cannot be a correct interpretation of the way the rating agencies evaluated MBS: “I have found no clear evidence that [the CRAs] saw danger in ASB CDOs [type of MBS] and ignored it for the sake of fees...On the contrary, the evaluation of ABS CDOs...is plausibly interpretable as organizational

⁵⁵ As Hill argues: “Consider that rating an instrument much higher than its quality warrants almost certainly can’t work in the moderate term. A rating agency is consulted for its ratings only because those ratings are deemed by investors to be accurate. Issuers are paying for ratings, but if investors think high ratings can be bought, the rating will be worthless, and rating agencies will lose their business...the short term payoffs were high...but they weren’t making enough money to look as foolish as they do now, or be as vulnerable to litigation and more onerous regulation” (2010, p. 596).

routine” (2011, p. 1830).⁵⁶ The overall picture that emerges is one in which the rating agencies managed to convince themselves, as did so many actors, that these complex financial products warranted the ratings the agencies had assigned to them (Hill, 2010).

Why, however, have the agencies’ profits continued to increase despite this crisis occurring? The answer is the way in which the state – which as discussed in Chapter 4, has an interest in the agencies’ existence – has chosen to discursively respond to the crisis and re-legitimize the rating business through a variety of regulatory initiatives. This will be discussed in the next section.

Part 3: Crisis as Governance

The heavy blame placed on the supposedly fraudulent rating agencies has consequences regarding how we view neoliberal globalization. As former Moody’s rating analyst William Harrington testifies to the FCIC, “The rating agencies have been the all-purpose bogeymen for the crisis. They bear a heavy responsibility, absolutely, but this exclusive focus obscures how the problems are embedded in the whole system: the big banks, accountancy firms, financial law firms, investment firms, regulators and the financial press” (Luyendilj, 2012). While the FCIC highlighted various wrongdoings, such as regulatory failure and conflict of interest, it failed to adequately explore systemic behavioral patterns in financial markets. Flandreau discusses this point: the hearings so far are “more concerned with trying to establish wrongdoing in certain specific instances, rather than a general pattern” (2012, pp. 16-17).

Rather than seeking to change the system, such representations of crisis attempt to re-embed. The focus on the conflict of interest as a major cause of the financial crisis suggests that it occurred because “some people were not doing their jobs properly, were intervening in finance ineptly, and that if we can just make sure people do what they are supposed to do, another financial crisis like this can be avoided” (Sinclair, 2010, p. 101). Financial crises are continually depicted as the outcome of some form of deviance. These politics of blame represent an ideological effort to transpose the root of the crisis from the inherent

⁵⁶ Hill reinforces this argument: “The structured finance lawyers I have spoken to describe a more nuanced picture, in which rating agency employees seemed to be doing a mostly satisfactory job rating a high volume of exceedingly complex deals; indeed, the employees not infrequently demanded (sometimes costly) changes in the transaction structure to increase quality before giving a high rating” (2010, p. 340).

instability of neoliberalism to clearly identifiable actors and actions that are external to normal market activity (Sinclair, 2010). It adopts the most fundamental assumption of neoclassical economics: the idea of a self-equilibrating market. Neo-classical economists are unable to recognize that economic crises can occur as a result of the internal or normal operation of the economy (Nesvetailova, 2007).

Financial crises become serious because they destroy linguistic capital, particularly economic discourse. Crises thus create a need for reconstructive discourse, “in the same way accidents require reconstructive surgery” (Flandreau, 2012, pp. 1-2). Externalizing the causes of economic crises is a key method used by state and private actors to reconstruct pre-existing economic discourse and power relations. As discussed in Chapter 8, this represents a key strategy used by the New Zealand government following a credit rating downgrade as the external deficit is described as the primary cause of New Zealand’s economic woes. Discursive othering is used following financial crises to re-legitimize sovereign power and neoliberal market practices. Blame is attributed to certain deviant practices, thus normalizing and re-legitimizing pre-existing market practices: the Asian financial crisis was described in terms of lax regulation, fraud and corruption; the Subprime Crisis was orchestrated by the unscrupulous lenders and the corrupt rating agencies; and the Euro-crisis was driven by the corrupt and idle character of the Greeks (Sinclair, 2010; Mylonas, 2012).

Ultimately, the CRAs’ most consequential impact has not been the mispricing of financial risk, but the production of an authoritative framework of financial knowledge that supported the belief that it was possible to objectively determine and manage financial risk. Thus, the focus on the agencies’ problematic incentive structure misses the point. The idea that perverse incentives led the agencies to get the ratings wrong, assumes they can get them right. As Langley (2010) argues, it assumes that the agencies would have been capable of producing accurate ratings if an appropriate system of remuneration had been in place: “There is no acknowledgment of...the incapacity of risk valuations to fully capture incalculable future uncertainties” (Langley, 2010, p. 83). As Paudyn comments, “whether predictive positivism of this sort...helps us acquire ‘objective’ knowledge about fiscal behaviour is a misplaced enquiry. Given the uncertainty of budgetary politics, this risk-dominant approach searches for certainty equivalence that just

does not exist” (2012, p. 6).

It is precisely the focus on the bad subjective inputs in the rating process that enables the rating agencies to claim methodological objectivity. The prevailing idea is: *if we can remove subjective elements from the rating process, an objective measure of creditworthiness will remain*. This logic creates what Paudyn (2012) terms a fictitious qualitative/quantitative opposition, in which objective quantifiable risk is considered separate to, and distinct from, subjective qualitative uncertainty. This distorts the way in which subjective opinion and uncertainty are in fact embedded within such quantitative practices and has also led to the distorted regulatory aim of producing objective ratings. In 2008 the European Commission proposed regulation that aimed at “ensuring that credit ratings used in the community are independent, objective and of the highest quality” (Amttenbrink & De Hann, 2009, p. 1915). The Permanent Subcommittee described financial modelling techniques as being “handicapped” by subjective inputs (Permanent Subcommittee, 2011, p. 28). This creates a problematic binary between quantitative risk calculation and subjective opinion. The focus on removing subjective bias, whether political or monetary, serves to deflect attention from the contingent, subjective and uncertain nature of the risk modelling techniques themselves and the financial theory they are based on, which are left unquestioned.

This state-based discursive response to the financial crisis effectively re-legitimized the credit rating business whilst simultaneously removing the state from any obvious culpability with regard to empowering these institutions through regulatory changes. It is thus unsurprising that despite the barrage of criticism levelled against the CRAs over the last decade, little discernible impact to their perceived expertise, market dominance or profitability has occurred. If anything, McVea argues, “throughout much of this period CRAs [have actually] succeeded in enhancing their influence” (2010, p. 709). The story of the hedge fund Long-Term Capital Management (LTCM) is a good example of this dynamic occurring.

We have already witnessed the resurrection of scientific approaches to finance in the notorious story of the 1990s hedge fund LTCM. The story of LTCM illustrates the consequences of externalizing the

causes of financial volatility. LTCM was a very large hedge fund with assets totalling roughly \$100 billion.⁵⁷

The fund was regarded as a bastion of financial credibility and included some of the most prominent members of the world's financial community (de Goede, 2001). Its creators were the authors of the Black-Scholes formula: Myron Scholes was the founder of LTCM, and Fischer Black was on the board of directors. LTCM was underpinned by the Black-Scholes formula, the centerpiece of which was that through dynamic hedging – the purchasing of large amounts of financial derivatives – traders could effectively eliminate risk.

Initially the fund was extremely successful, putting up returns of 40% a year. As Lowenstein comments, “The fund’s intellectual supermen had apparently been able to reduce an uncertain world to rigorous, cold-blooded odds” (2000, p. xix). However, in early 1998 LTCM started to take heavy losses; this eventually culminated in a single trading day loss exceeding US \$500 million. By September that year LTCM was forced to seek assistance from the New York Federal Reserve to avoid bankruptcy, and was eventually liquidated in the early 2000s. As a result of LTCM’s failure and the cost of the bailout (totalling nearly \$4 billion), in 1988 the US House of Representatives began to hold hearings on the role of hedge fund operations in the financial system. Similar to the current criticism of CRAs, the former SEC President David Ruder spoke out in favor of tightly regulating hedge funds: “Our capital markets should not be held hostage to the activities of a group of risk-takers who can operate in secrecy without regard to possible systemic effects” (in de Goede, 2005, p. 134).

The result of such regulatory pressure was the passing of the Hedge Fund Disclosure Act (HFDA), which required hedge funds to publicly disclose the size, composition and risk of their investment portfolio (US House of Representatives, 2000). Two key points defined this act. First, LTCM was seen as an aberration to normal market activity: the market turmoil associated with the LTCM disaster was seen as irrational and rare. Second, LTCM was characterized by poor and reckless upper management who were unique in the amount of leverage they took on. The SEC argued that under normal circumstances hedge funds played a positive role in maintaining the smooth operation of financial markets by contributing to the efficient

⁵⁷ Hedge funds are private investment partnerships. Because historically hedge funds are not sold to the public, but to a certain class of investors (i.e., accredited investors), they have been exempt from regulations that govern other types of investment funds. These regulations include limitations on the level of risk able to be taken.

allocation of capital. The burden of blame was thus limited to the institution's risk-taking upper management and abnormal market circumstances. The risk management techniques used, the practice of arbitrage itself, and the financial theory that underpinned it, were never questioned.

Rather than being an aberration, if one looks at the financial techniques used by LTCM, most notably the Black-Scholes formula, they represent the epitome of modern scientific approaches to finance. LTCM was indeed the quintessential hedge fund of the 20th century. It was an experiment in harnessing the market through financial theory and computer programming, and therefore was an experiment that was replicated. The belief that tomorrow's risk can be inferred from yesterday's prices and volatilities prevails at virtually every investment bank and trading desk (Lowenstein, 2000). The failure of LTCM, similar to that of CRAs, is at the heart of modern finance, it is the belief in the scientific calculability of future risk. The collapse of LTCM lies its failure to acknowledge the irredeemably social and uncertain nature of financial markets: "Unlike dice, markets are subject not merely to risk, an arithmetic concept, but also to the broader uncertainty that shadows the future generally...uncertainty, as opposed to risk, is an indefinite condition, one that does not conform to numerical straitjackets" (Lowenstein, 2000, p. 235).

The attempt to regulate hedge funds and limit their influence did not restrain their operations, but re-legitimized their existence and the financial risk-calculating techniques underpinning their market operations. As de Goede argues, the HFDA act should be seen as a "depoliticization and normalization of hedge fund activity...it created a legitimate domain for hedge funds to operate, and stabilized the controversy surrounding hedge funds" (2005, pp. 135-136). The growth in the hedge fund industry over the last decade illustrates this point: in 1998 the total assets managed by hedge funds was US \$35 billion, by 2005 that figure rose to over \$1 trillion dollars (Danielsson, Taylor & Zigrand, 2005). Recent attempts to regulate CRAs have similarly failed to question the foundations of the credit rating and have therefore stabilized the controversy surrounding CRAs, depoliticized the credit rating practice, and normalized CRAs' role in the financial system.

Conclusion

This chapter has attempted to shift attention away from the CRAs and towards a greater focus on the credit rating itself and the role of social norms and beliefs in generating the perceived objectivity of these credit evaluations. The way in which credit judgements are presented is vital to the current significance of the CRAs. The uncertainty absorption caused by the form of the credit rating, along with the opaque nature of the generation process, removes from view the subjective and political elements within the credit rating process. As was illustrated by exploring the causes of the Subprime Crisis, social beliefs and practice do indeed play a determinative role in financial market actors' behavior. Finally, by highlighting how the US state was able to reconstruct pre-existing market apparatuses and power-relations following economic crises, the role of states in the discursive construction of the market is brought to light. The significance of the credit rating form and the role of the state in the discursive construction of the market will be further demonstrated in the next two chapters; both observations have significant consequences regarding how we view state-CRA interactions.

Chapter 7: Hitching a Ride on the Tiger's Back

Introduction

This chapter sets out to accomplish three tasks. First, a brief history of New Zealand's neoliberal experiment will be given. A key point here is that New Zealand's neoliberal experiment cannot be explained as a direct response to global economic forces. With relatively little international pressure, the New Zealand government chose to play a decisive role in the initiation, implementation, and continuation of the neoliberal reform process. In discussing the means by which the government was able to further the neoliberal project – specifically, the strategic use of globalization discourse, along with the selective interpretation of certain private actor recommendations – the dichotomized and antagonistic nature of state-market, national-global and public-private relations are questioned. Second, a methodological outline for the New Zealand case study in Chapter 8 will be given. This will discuss where the data for Chapter 8 was collected, how it was collected, and what the key findings were. Finally, as a prelude to the final chapter, the last section will address the market's reaction to changes in New Zealand's credit rating.

The political-economic history of New Zealand is one of striking contrasts. The once widely accepted and praised welfare state of the 1940s and 1950s was by the 1990s all but destroyed. New Zealand's rapid implementation of a neoliberal economic reform program throughout the 1980s and 1990s was one of the most radical in history. The New Zealand case illustrates how governments are able to interact with, and at times co-opt, the authority of non-state actors as a means of furthering the domestic political project. The point is to highlight that the judgements of IOs and private actors do not necessarily erode the decision-making autonomy of governments, but can, in fact, enhance it. Governments, however, cannot unproblematically use private expertise in pursuit of their own interests. Rather, as the following examples illustrate, states are able to reinterpret such recommendations, within certain *degrees of interpretation*.

Part 1: Making Thatcher look Timid

Following the Great Depression, the New Zealand government adopted a state-market development model characterized by heavy state involvement in the economy, high social spending, and protection against overseas competition through the use of tariffs and import licenses (Challies & Murray, 2008). After the election of the first Labour government in 1935, New Zealand politics was dominated by the rise and entrenchment of Keynesianism and an embedded socialist sentiment that dominated political culture. The 1938 Social Security Act, which included a series of policies defined to ensure material security and economic equity for all citizens, marked the government's commitment to welfare at the time (Larner, 1998).

However, echoing the global economic trends of stagflation, market volatility, and mass unemployment that characterized the 1970s, the New Zealand economy entered a downturn and so too did confidence in Keynesianism as a strategy of economic management (Roper, 2011). The downturn was exacerbated when Britain, New Zealand's largest trading partner at the time, entered the European Economic Community (EEC) and New Zealand lost its privileged trade access. Responding to New Zealand's economic woes and falling confidence in the country's economic management, Robert Muldoon's National government began borrowing large amounts from overseas to increase public spending and combat rising unemployment. Muldoon engaged in a number of large investments in heavy industry, known collectively as Think Big. This highly interventionist approach culminated in a wage and price freeze instituted in 1982. Thus, in the early 1980s the New Zealand economy was one of the most protected and controlled in the world (Challies & Murray, 2008).

By 1984, as the economic decline worsened, discontent over Muldoon's heavy-handed Keynesianism grew stronger. Hostility to Muldoon and his government's interventionist tendencies coincided with a more widespread and bipartisan critique of state management (Larner, 1997). Such discontent reached a critical mass when Muldoon was defeated by the Labour party in the 1984 elections. This election marked the date where Keynesianism was abandoned and market fundamentalism began. By the mid 1980s, the belief in extensive state involvement and service provisions started to be questioned

(Larner, 1997). From 1984 to 1990, Labour implemented one of the most comprehensive programs of neoliberal reform in history. Prime Minister David Lange, along with his ambitious Minister of Finance Roger Douglas, led the reform process, which, while in some ways reflecting public sentiment at the time, was implemented largely without public consultation. Because gaining the unwavering consent of the populace is difficult, the “freeing” of markets tends to coincide with a strong government that circumvents the democratic process and insulates key economic activities from political intervention (Kelsey, 1999, pp. 6-7). This was particularly important in this case given the widespread public opposition towards privatization policies.

The NZ Treasury, who was at the time increasingly gaining a competency monopoly in economic policy,⁵⁸ attempted to respond to New Zealand’s precarious macro-economic situation with the application of neo-classical economic theory in a form closely resembling the Washington Consensus, as captured in the 1984 briefing paper “Economic Management”. The government adopted a monetarist policy to control inflation; the currency was allowed to float; the labour market was deregulated and the financial market liberalized; and government spending was reduced and assets privatized (Kelsey, 1999). These reforms were so far-reaching, rapid, and ideologically pure, they have been described as “Making Thatcher look Timid” (Menz, 2005, p. 49). The New Zealand experiment can therefore be associated with a shift from a “welfare” to a “competition” state, that is the move in governmental policies away from the goal of welfare maximization towards the promotion of enterprise, innovation and profitability in both private and public sectors (Larner, 1997).

The international community and media initially praised the New Zealand experiment as an international model for economic reform. Yet, with regard to key economic performance indicators, the New Zealand economy began to rapidly deteriorate in the late 1980s. Between 1985 and 1992 the average OECD growth rate was 20%, but the New Zealand economy shrank by 1%. Unemployment rose to unprecedented levels and inflation began to average around 9% a year (Kelsey, 1997). Due to the country’s

⁵⁸ Every submission placed before Cabinet that had economic, financial, or revenue implications required the Treasury’s endorsement. This was significant because the Treasury was “without doubt, the driving force behind the structural adjustment program” (Kelsey, 1997, pp. 49-50).

continuing economic stagnation throughout the 1980s, the National government came to power with a landslide victory in the 1990 election. The National party, however, demonstrated equal, if not greater, ideological conviction to free-market fundamentalism. Following National's election, the party began to argue that the dire economic indicators were the result of a slow and diluted reform process; in typical neoliberal fashion, the solution to the failure of market-led development was more markets. These reforms were thus based on a strong ideological commitment to free-market principles and consisted in a disregard for key economic performance indicators.

National's growth strategy revolved firmly around reducing government spending, but its success was questionable at best. By the early 2000s it appeared as though the "wheels were coming off the New Zealand experiment"; even its staunch defenders conceded that the reforms were "far from optimally executed" (Menz, 2005, p. 50). Following this admission, the New Zealand government adopted a similar approach to Third Way politics in Britain. Such policies are defined by a synthesis between right-wing economics and left-wing social policies and a distinct proclivity towards a more socially interventionist economic strategy. Because neoliberalism is a dynamic, evolving and crisis-driven project, these changes did not signify an "end of neoliberalism" – as Helen Clark claimed in 2002 -- or even a shift towards some form of post-Keynesianism economic management, but rather involved the "continuation, consolidation and normalisation of the neoliberal model...and the mainstreaming of the underlying ideology across the political spectrum" (Challies & Murray, 2008, p. 236).

Drawing from the structuralist theoretical tradition, most analysis of the New Zealand experiment describes New Zealanders – especially Māori, women, and workers – as the hapless victims of global economic forces (Larner, 1997a). However, certain critical histories of the New Zealand experiment note a distinct lack of international pressure as a defining feature of the reform process (Menz, 2005; Larner, 1998). When put in historical perspective, the New Zealand case is rather puzzling. Despite the lack of pressure from international financial institutions, such as that experienced by a number of Latin American countries at the time, the New Zealand experiment essentially mimics the policies prescribed in the Washington Consensus (Menz, 2005). While it was clear that the New Zealand economy required a degree of reform in

the 1980s, the Labour government, as Kelsey argues, “chose to take the Washington Consensus to its neoliberal extreme...the international economy was little more than a backdrop to this domestic policy agenda (1997, pp. 19-20). New Zealand’s aggressive strategy of internationalization involved the deliberate exposure of the domestic economy to global financial capital so as to promote efficiency in the domestic economy.

Criticising the common “no alternative” logic, Wendy Larner argues that the current emphasis on globalization in New Zealand is not the inevitable response of a small, dependent, settler economy to the emergence of a globalized world economy: “[G]lobalization is not a prediscursive fact – a ‘new reality’ that has forced the New Zealand state and its citizens into new roles. Rather...political ambitions and social practices together constitute globalization as the predominant representation of economic life in New Zealand” (*italics added*, 1998, p. 600). Key to globalizations influence is its representation as a force that requires certain policies to be implemented. Understanding the performative nature of economics suggests that processes of knowledge and interpretation are not of secondary importance to real material structures, but are precisely the way in which economics materialize. This point is significant given the way in which the National government, as detailed in Chapter 8, used concerns over maintaining New Zealand’s international credit rating as justification for domestic policy reform.

The New Zealand case was unique not only because it lacked international pressure, but also because it had a distinct lack of any socio-cultural tradition associated with free-market ideology. Keynesian economic management, heavy state interventionism and a sizable welfare state were all prominent features of New Zealand’s political-economic landscape and were widely accepted by the populace. The celebration of free-markets was particularly unfamiliar to the New Zealand public. As Menz comments, the neoliberal policies implemented were “not only more radical than Thatcherism but also much more alien to New Zealand’s political-economic culture, which had embraced state interventionism” (2005, p. 57). The lack of international pressure and the alien nature of market fundamentalism to New Zealand’s cultural landscape meant the New Zealand state played an extensive role in constructing the social foundations that underpin its market society.

Two strategies are common for the implementation of neoliberal reform. The first involves insulating key elements of economic decision-making from democratic contestation by designating them as technical; this is typically achieved through the quasi-legal restructuring of the state (Gill, 2008). In a typical new-constitutionalist move, the New Zealand government created an independent central bank with the Reserve Bank Act of 1989. In addition, “[i]n distinguishing between ‘productive’ and ‘non-productive’ activities in the state sector, Treasury discursively separated out the ‘economic’ from the ‘social’ in government departments” (Larner, 1997, p. 18). “Economic” activity was to be governed by market principles. The State Owned Enterprises Act of 1986 separated state trading enterprises from the non-commercial functions of the state, and granted these enterprises a commercial mandate in order to subject their governance to the criteria of market efficiency (Larner, 1997).⁵⁹ Within this context it can clearly be said that “any frontier separating...the economic sphere from other social spheres [is] contingent and precarious and wholly dependent upon historical construction and not on an *a priori* division of necessity” (Daly, in Larner, 1997, p. 18).

The second strategy for implementing neoliberal policies involves the government adopting a more socially interventionist stance in order to generate self-regulating subjects. The goal of such governmental interventions, which are often dialogical in nature, is to make neoliberal policies seem like common sense or without viable alternatives. Arguments depicting New Zealand’s neoliberal transformation as simply a result of political manipulation or the disciplinary power of capital insufficiently capture the tenacity of neoliberalism in NZ. As Larner explains:

Not only are both major parties now advocating variants of market-led policies, it is also noticeable that despite the apparent unpopularity of the so-called “free market revolution,” many New Zealanders have begun to frame their political claims in the language of choice, flexibility and the market. To argue that this phenomena is simply the outcome of effective “political manipulation” is an inadequate response that does no justice to the capabilities of those involved. (1997a, p. 12)

In their 1987 paper the “Brief to the Incoming Government”, Treasury was explicit in its promotion

⁵⁹ While the state owned enterprises (SOEs) were initially created to achieve both social and economic goals, by the 1990s, as the discourse of competitiveness became more entrenched, the idea emerged that the social goals were only eroding economic efficiency. Privatization was then identified as a means to solve this “problem”.

of competition as the means to enforce economic efficiency (Larner, 1997a). The government would, through various deregulatory measures, empower the market to adopt the governance role traditionally undertaken by state regulation. Markets, however, are not pre-existing entities, but must be created both institutionally and discursively. Deregulation therefore did not entail a decline in political power, but the complement of one form of state-based governance by a market-based one. This new form of governance involved the “dispersal of political power to organizations outside the state, and the emergence of a plurality of forums through which different aspects of political activity could be co-ordinated” (Larner, 1997a, p. 29). New Zealand’s domestic economic activities have become increasingly coordinated with international markets and private actors. This entailed a reimagining of the spatial geographies of the New Zealand economy, which was no longer coterminous with the nation-state, but embedded in global capitalism (Larner, 1998).

The justification for economic policies began to shift in the 1990s from domestic concerns to international requirements. In order to justify the neoliberal policies the “inescapable” logic of globalization was often invoked. A 1990 briefing paper by Treasury argued, “We cannot escape the effects of changes taking place elsewhere in the world. We need to adapt” (in Kelsey, 1999, p. 9). As noted, globalization is not an external material constraint imposing discipline on policy-makers. Rather, domestic political actors can promote and strategically use the discourse of globalization. As Kelsey comments, “The mythology of globalization is enormously powerful...it allows governments to abdicate responsibility for the consequences of their own policies, laws and practices; it justifies a refusal to consider alternative policies that might cause less harm to people, communities, and their environment” (1999, p. 56). In responding to the dictates of globalization, citizens are encouraged to view themselves and their countries as rational economic actors whose success is judged by the criteria of international competitiveness. The cutting of social spending, for example, was justified in terms of “encouraging and enabling people to work smarter, produce more, and compete harder in the international arena” (in Larner, 1998, p. 605).

These new forms of economic governance involve the strategic dispersal of political power to organizations outside the state. Such organizations include international organizations (IOs) and private

actors who recommend certain economic policies, such as the OECD. These actors are typically seen as eroding the decision-making autonomy of government, but this neglects how the travel of ideas is an active process of translation. The carriers of ideas are active agents in the process of translation, reflecting in the process their own interests and purposes (Djelic, 2008). Domestic political interests often filter international policy recommendations. The country reports published by the OECD are, for example, often negotiated with, and signed off by, governments. If criticism survives it is often relegated to footnotes, while the major policies the government wants to include are generally recommended in the report (Kelsey, 1999).

IMF reports display a similar dynamic. The reports are not public documents; summaries however are released with government permission. This makes it difficult to access the data used, and to challenge the assumptions, conclusions or policy prescriptions (Kelsey, 1999). The opaque nature of the judgement process, along with the inaccessibility of the full report, allows governments to use these reports to domestic political advantage. There are striking similarities here between IMF reports and credit ratings, particularly in how the inaccessibility of the full reports grants governments a degree of flexibility when interpreting the recommendations. One could argue that while the New Zealand government interpreted such reports, they nonetheless maintained a common, neoliberal, ideological framework. However, as the next chapter will make clear, moving beyond the assumption that such actors promote a uniform set of neoliberal policies, or that one even exists, is crucial to understanding the role played by states in interpreting the rating agencies' judgements.

The Competitiveness Reports published by the World Economic Forum are another example. Jeffrey Sachs, chair of the advisory board for the reports, clearly states that the reports should be considered subjective opinions, with many limitations. Despite this assertion, the New Zealand government has "systemically ignored these caveats...the rankings regularly appear as objective facts in government speeches and Budget Statements" (Kelsey, 1999, p. 84). Again, comparisons emerge with credit ratings. As will be discussed, despite the very clear stipulation by CRAs that ratings are subjective opinions, the New Zealand government has chosen to strategically and selectively describe credit ratings as either objective facts or subjective opinions depending on political circumstance. As the IMF, OECD and Competitiveness

Reports illustrate, the policy making autonomy of governments is not necessarily being eroded by such surveillance mechanisms. Governments can simultaneously enhance their power and the expertise of non-state actors. When political power is investigated this way, it is not reducible to the actions of the state as a “relatively coherent and calculating political subject”, but to the multiplicity of forces and groups involved in governance (Miller & Rose, in Larner, 1998).

The purpose of highlighting the role of governments in interpreting such reports is to bring the state back in to the study of private power. Expertise is key to this form of governance as it forms the link between the socio-political objectives involved in governing and individual subjectivity. Expertise is, however, not solely generated by private actors for private purposes. As Rose notes, “Expertise can...be mobilized within political argument in distinctive ways, producing a new relationship between knowledge and government. Expertise comes to be given a particular role in the formulation of programs of government and in the technologies that seek to give them effect” (1998, p. 156). While the state cannot entirely reinterpret private actor recommendations, as it must maintain a semblance of consistency with the reports, it can nonetheless still play a role in interpreting, and giving emphasis to, certain recommendations and actors.

Within existing scholarship on CRAs there is little to no mention of the specific means through which ratings orthodoxy – that is, the economic policy preferences of the CRAs – is transmitted. By neglecting the various characteristics of credit ratings, current approaches insufficiently consider the role that governments can potentially play in interpreting ratings changes. By focusing on the dynamics of uncertainty absorption and the opaque nature of the rating process, one can begin to see how governments are able to play a role in interpreting what a credit rating change means. Negative rating changes can represent an opportunity for governments. Jane Kelsey argues that while governments often seek to avoid a downgrade, they can use the fears associated with a credit downgrade to justify deeply unpopular and unsuccessful policies. In New Zealand during the 1990s, “the mere suggestion of a rating review quickly became a justification for keeping the neoliberal [project] on track...affirmation from the agencies provided the carrot to balance the stick” (Kelsey, 1999, pp. 77-80).

Following the 1990 election a double downgrade was predicted. Ruth Richardson, the Finance Minister at the time, attempted to take advantage of the situation. When, in 1991, S&P downgraded New Zealand's rating one notch to AA- Richardson claimed a victory; a double notch downgrade, she argued, would have meant sovereign lenders would have "shut the door on...lending." Now, as she put it, "we need to be able to hold on to the credit rating we've got" (Kelsey, 1999, p. 81). Using this "need" as justification for a pre-existing policy agenda, Richardson created the "mother of all budgets" that deeply slashed government spending: "The New Zealand government made themselves willing captives of the credit rating agencies...because the ratings offer another means to legitimize their policy position, secure a political advantage and resist demands for change" (Kelsey, 1999, p. 83). We should be wary of accepting uncritically that CRAs leave states with no alternative other than to capitulate to the demands of international investors, because to do so effectively denies the possibility of democratic governance of economic processes in contemporary society.

Part 2: Methodology

Drawing largely on parliamentary and media sources, Chapter 8 will explore the interaction between the New Zealand state and the CRAs between 2008 and 2012. The focus is on how various actors describe, and react to, changes in New Zealand's credit rating. The state here refers to Gramsci's conception of the integral state, which includes political and civil society. A substantive separation between these spheres is based on a theoretical error as they represent the respective dualities of ruling—coercion and consent. By adopting this definition of the state, the possible sphere of inquiry expands. NZ-CRA interactions include various heads of state, opposition party members, the New Zealand media and the New Zealand public.

The focus is on the 2008-2012 period due to the extraordinary degree of turbulence between the CRAs and the government throughout the period and the accompanying abundance of discussion about the rating agencies within both the New Zealand media and parliament. There was little mention of the credit rating agencies from the early to mid 2000s. Between April 2001 and May 2008, there were only two

changes to New Zealand's sovereign rating. This compares to six changes that occurred between 2008 and 2012, a much smaller time period. Here a change in outlook is considered a rating change. While they are technically different, a change in outlook provokes similar levels of debate; and as some economists argue, outlook changes can actually have a greater market impact than rating changes. While the actual ratings changes date from 2009 to 2011, the dates of inquiry have been expanded to 2008-2012 in order to gain a wider perspective on how credit ratings are being referred to in political discourse. The table below summarizes the changes to New Zealand's credit rating.

Table 3: Changes to New Zealand's Credit Rating (2008-2012)

Agency	Date	Changed from	Changed to
S&P	13 th January 2009	AA+ (stable outlook)	AA+ (negative outlook)
S&P	28 th May 2009	AA+ (negative outlook)	AA+ (stable outlook)
Fitch	16 th July 2009	AA+ (stable outlook)	AA+ (negative outlook)
S&P	22 nd November 2010	AA+ (stable outlook)	AA+ (negative outlook)
Fitch	29 th September 2011	AA+ (negative outlook)	AA (stable outlook)
S&P	30 th September 2011	AA+ (negative outlook)	AA (stable outlook)

The New Zealand case was selected in an attempt to move away from typically exaggerated accounts of CRAs' power. The impact of rating downgrades and outlook changes have historically been explored in only severe, generally one-off, cases of financial turmoil and fiscal crisis.⁶⁰ The outcome of focusing on such dire situations of short-term fiscal duress is an exaggerated and normalizing description of CRAs' power. The comparatively long time period discussed here, which includes multiple rating and outlook changes, was selected in an attempt to remedy this focus on one-off rating changes that obscure the contingent and dynamic nature of state-CRA relations. Finally, exploring the New Zealand case, a country that lingers in-between AAA and AA, i.e. margins of excellence, is a useful strategy to question the prevailing discourse that describes CRAs as maintaining a hegemonic influence over sovereign states. While a sovereign downgrade to junk status may indeed cause a substantial increase in a government's borrowing costs, the consequences of a shift from AAA to AA is much more indeterminate. Given that New Zealand

⁶⁰ The power of CRAs has been discussed in relation to the European sovereign debt crisis (Paudyn, 2012), the Irish and Hungarian fiscal crises in 2010 (Priebe, 2012), the Detroit bankruptcy in 1992 and the Asian finance crisis (Sinclair, 2005).

remains within such degrees of excellence, how politicians describe the threat of a downgrade is of particular interest.

The data on New Zealand's parliamentary debates was collected through the use of Hansard, a database that records all parliamentary debates and supplementary data. The analysis presented here was greatly facilitated by the parliamentary debates being available online in electronic form at the New Zealand parliamentary website (www.parliament.nz/en-NZ/PB/Debates/Debates). This enabled a critical analysis of all references to, and discussion on, the CRAs within the given time period. The key search phrases used to find this data were: credit rating agencies, credit ratings, rating agencies, CRA, Standard and Poor's, S&P, Fitch and Moody's. A total of approximately 33,000 relevant words were drawn from this search.

Several close readings of the data were undertaken in order to identify key discursive frames. How politicians chose to describe credit ratings, and international financial markets more broadly, was notably discontinuous and changed according to the political climate. Governments, as noted, occupy a spatially promiscuous position between the national and the global. They are able to dip into the discursive power of the global realm to bolster their domestic position – such as by invoking globalization and “no alternative” logic – and they can also dip into the domestic sphere to resist global economic forces. The New Zealand case illustrates how the National government “dipped into the global realm” by selectively espousing CRAs as expert economic commentators and financial markets as homogenous entities whose will coincides with the agencies' judgements. It also illustrates how the National government “dipped into the domestic realm” by promoting a nationalistic discourse that demonized the idea of an outside actor influencing government policy. These discursive frames are identified in Table 4.

Table 4: Credit Ratings in Political Discourse

	Nationalist discourse	Globalist discourse
Credit ratings	Subjective opinions of economic performance.	Objective indicators of economic management.
Cause of rating change	Changes in the external economic environment, (e.g., increased sensitivity to debt levels).	Ineffective economic management by the government.
Economic outcome of rating change	Financial markets are heterogeneous. CRAs have one opinion among many. Market outcome is uncertain.	Financial markets are homogeneous. Rating agencies guide international investors. Market outcome is an increased cost of borrowing.
Policy outcome of rating change	New Zealand government as the sovereign decision-maker. No direct influence on government policy.	New Zealand is part of the global economic system. Policy adjustments are necessary requirements for economic success.

The data collected from the New Zealand media was gathered using a combination of the *Australia/New Zealand Reference Centre*, a database that specializes in news articles in the Australia-New Zealand region, and the Google search engine for a broader, but less specialized search. The news articles referred to were drawn from a variety of different newspapers with a wide spectrum of ideological persuasion. The newspapers included: the more right-wing *National Business Review*; the more moderate *New Zealand Herald*; *Stuff.co.nz*; *The Dominion Post*; and also more left-wing papers, such as *The Standard*. The media sources were predominantly domestic in origin although a few international newspapers were added for an international dimension, including *The New York Times*, *The Wall Street Journal*, *The Guardian* and *The Economist*. Approximately one hundred articles were found and analyzed. The data from the media sources is focused largely on discursive frames identified above.

The primary aim is to question the nature of CRAs' power and its relation to the decision-making autonomy of governments. CRAs' power has traditionally been seen as either state-sanctioned, via regulatory incorporation, or private, and is said to erode government autonomy. Both of these assumptions are questioned. In order to do so a more detailed conceptualization of CRAs' power is developed. Gramsci's conception of the integral state allows us to expand our conception of what the state is, and how it is influenced. The integral state allows us to explore the economic, social and political components of CRAs' power, which can therefore be broken up into three components: international investors (economic),

domestic constituents (social) and local political actors (political).

First, CRAs are described as having power over international investors and are said to guide their investment decisions. Thus, as CRAs promote a certain economic orthodoxy, governments are seen as being restricted in terms of what economic policies they can pursue due to fear of a negative market reaction. Second, CRAs can be said to influence domestic societies and change the way local citizens view the actions and policies of their government. In effect, a downgrade can provoke ideas of economic mismanagement and incite a realignment of government policy around ratings orthodoxy due to shifting public opinion. Third, CRAs are seen as wielding political power in the sense that they are able to influence the decisions and policies made by local political actors. Due to their expertise in the area of economic policy, CRAs maintain consent-based authority over political actors in the sense that politicians *believe* in their advice and expertise. The idea that CRAs erode national sovereignty can thus be broken down into these three components: economic, social and political.

Part 3: How Markets React

Before discussing the socio-political reaction to changes in New Zealand's credit rating, it is necessary to discuss how the market has reacted to rating changes. CRAs are commonly described as having a determinative influence on market trends, specifically those related to interest rates and exchange rates. These indicators are particularly significant as they have an obvious affect on the government's policy autonomy. Focusing on these indicators, this section will explore how the market reacted to the six changes in New Zealand's credit rating between 2009 and 2011.

Table 5: Changes in NZD/USD 2009-2011⁶¹

Date	Change in rating	Year Prior	Month Prior	Day Prior	The day	Day after	Month after	Year after
13 th January 2009	Downgrade	.7149	.5569	.5887	.5745	.5536	.5151	.7216
20 th May 2009	Upgrade	.7149	.5709	.5974	.6017	.6065	.6374	.7216

⁶¹ All data presented here was collected from the statistics database for the Reserve Bank of New Zealand (Source: www.rbnz.govt.nz/statistics/).

16th July 2009	Downgrade	.7149	.6437	.6399	.6484	.6473	.6754	.7216
22nd November 2010	Downgrade	.6352	.7501	.7785	.7797	.7728	.7504	.7923
29th September 2011	Downgrade	.7923	.8384	.7888	.7744	.7697	.7879	.8102
30th September 2011	Downgrade	.7923	.8384	.7744	.7697	.7627	.7879	.8102

As Table 6 indicates, credit rating changes do have a clear short-term impact on New Zealand's exchange rate. Six out of six ratings changes were followed by respective changes in the NZD either on the day or the day after. The long-term impact, however, remains fairly minimal. Despite being placed on negative outlook in July 2009 and November 2010, the NZD continued its upward trend, as illustrated in Figure 1. This continued to July 2011 when the NZD reached a high of US \$.84. After which, perhaps due to speculation regarding an upcoming rating downgrade, the NZD started to drift downward. This trend continued as both Fitch and S&P downgraded New Zealand's credit rating in September 2011. By December the NZD reached a low of US \$.76. Yet, as Figure 2 highlights, while the NZD began a downward fall around September 21st, by October 4th it began to rise again and by February 2012 it was back up to pre-September levels.

Figure 1: Changes in NZD/USD 2009-2011

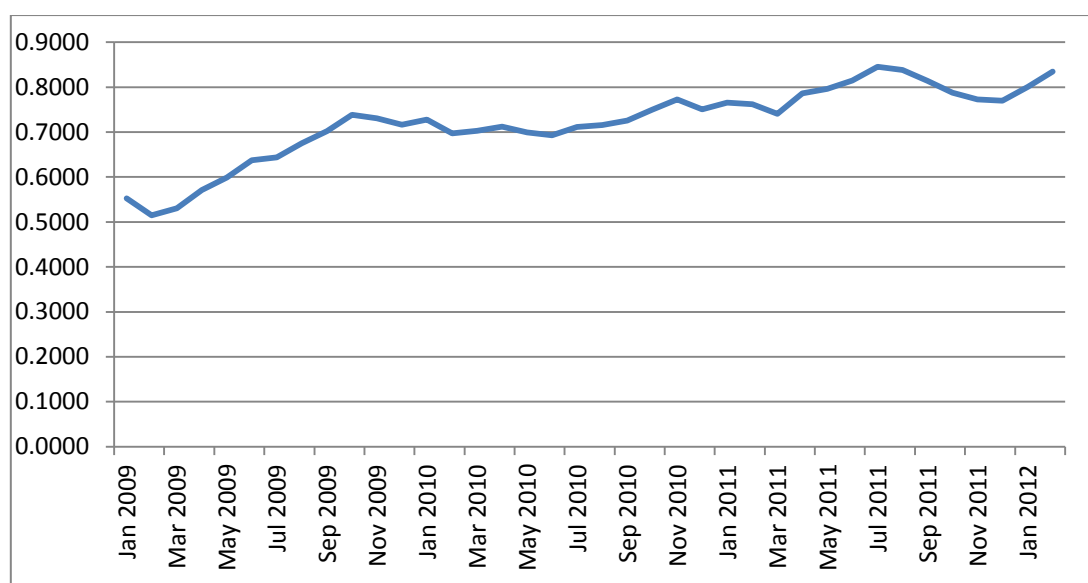
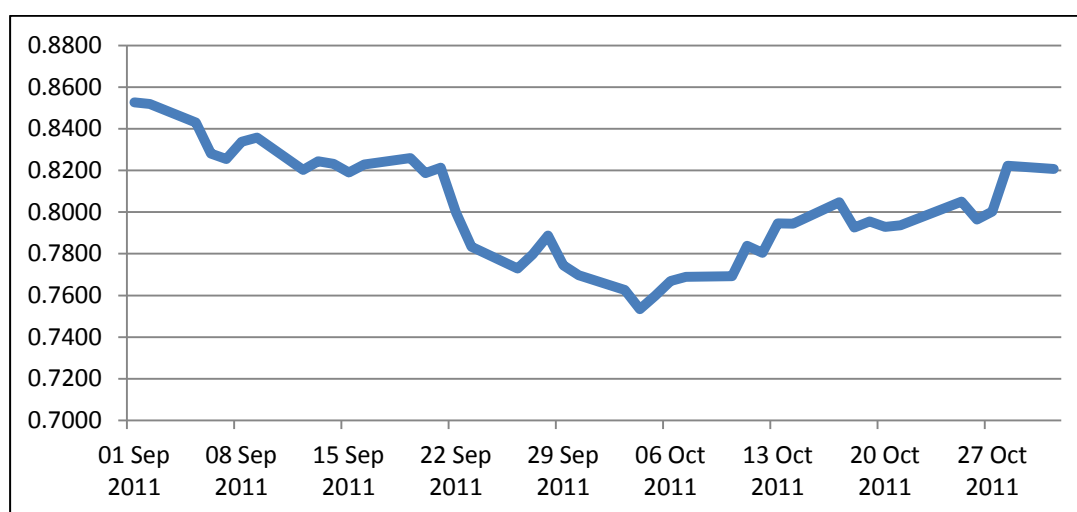


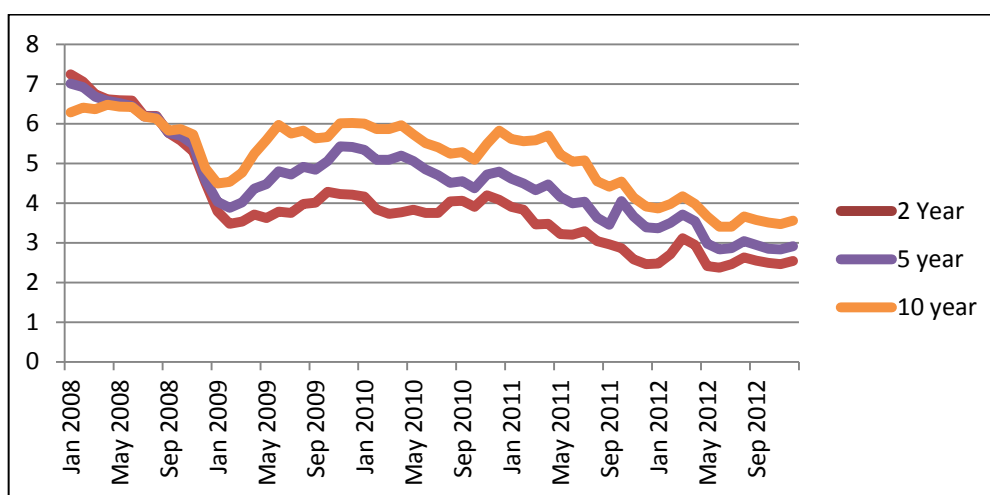
Figure 2: NZD/USD September-October 2011

These observations are corroborated by alternative analysis. The Commonwealth Bank (2011) commented that historically sovereign ratings downgrades have not tended to change the direction of the NZD; the currency has usually carried on with its existing trends. Moreover, in an 'Economic Update', ASB (2011) argued that following the 2011 double downgrades, the NZD continued to be driven by global economic trends, not New Zealand's credit ratings. ASB expected that over the medium term the NZD would find support in shifting commodity prices, improving global sentiment and improving GDP growth as a result of the Canterbury rebuild. They expected the NZD/USD to return to \$.80 USD by 2012. This observation came to fruition as following the downgrade the NZD returned to \$.78 within a month and \$.80 by January the next year. The influence of credit ratings on New Zealand's exchange rate cannot therefore be seen in isolation from existing market trends, but is context-specific and should not be taken for granted.

The data on secondary government bond yields illustrates a similar dynamic to the exchange rate. While ratings tend to have a short-term impact on borrowing cost, their long-term effect is minuscule relative to wider global economic developments. As Table 7 demonstrates, even their short-term impact is rather small. New Zealand's borrowing cost continues its downward trajectory regardless of a rating change. Figure 3 highlights the insignificance of credit rating changes on long-term interest rate trends.

Table 6: Interest rates on 10-year bond yields (2009-2011)

Date	Change in rating	Year prior	Month prior	Day prior	The Day	Day after	Month after	Year after
13 th January 2009	Downgrade	6.28	4.88	4.71	4.65	4.70	4.53	6.0
20 th May 2009	Upgrade	6.43	5.24	5.49	5.54	5.53	5.97	5.73
16 th July 2009	Downgrade	6.18	5.97	5.73	5.80	5.76	5.82	5.40
22 nd November 2010	Downgrade	6.01	5.09	5.65	5.66	5.71	5.82	4.11
29 th September 2011	Downgrade	5.28	4.55	4.31	4.34	4.39	4.54	3.57
30 th September 2011	Downgrade	5.28	4.55	4.34	4.39	4.42	4.54	3.57

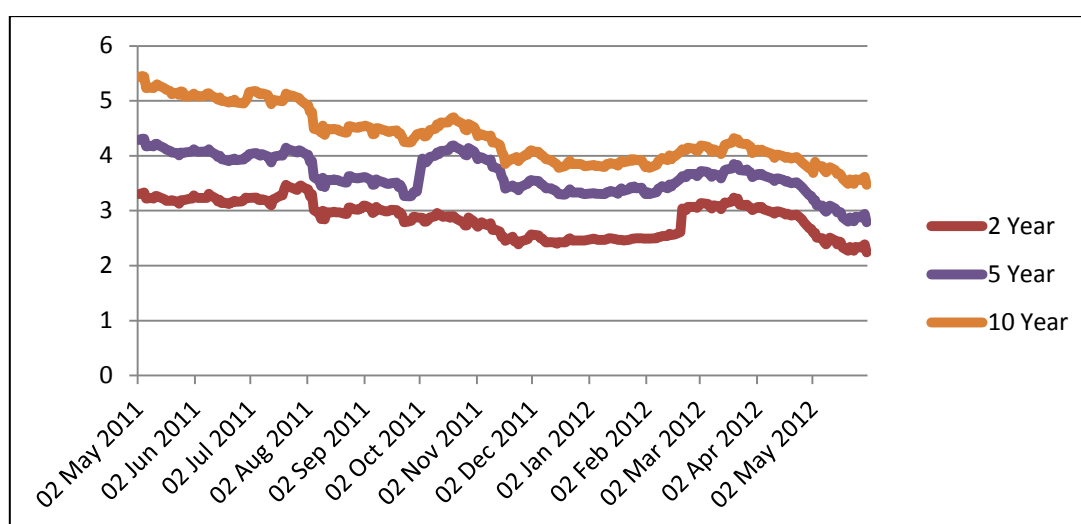
Figure 3: Government 10/5/2 year bond yields (2008-2012)

Interest rates continued to decline following the January 2009 outlook change. A noticeable upward shift began in February 2009. This trend continued until roughly November, and neither the May upgrade nor the July downgrade made any noticeable difference. Bond yields remained fairly consistent throughout January 2010. There was a short upward hike in October-November 2010 around the time of the November 22nd downgrade. Downward pressures, however, quickly ensued, and by December that year the rates on all three types of bonds headed downward.

The downward trend continued until the ten- and particularly the five-year bonds experienced a

noticeable hike following the September 2011 downgrades. Following this hike, as Figure 4 illustrates, long-term downward trends continued. Despite upward pressure on interest rates throughout September and mid-October, by October 17th both the 5-year and 10-year rates were heading down again. By mid-November the 10-year bond was even below pre-September levels, and by April 2012 interest rates on all three bonds were below targeted levels (Krupp, 2012). In May 2012, the NZ ten-year bond yields fell to a record low to 3.45 percent; the reason given for this was that investors were looking for “safer places to park their cash amid fears [that] Europe’s sovereign debt crisis may escalate” (McBeth, 2012).

Figure 4: Bond yields (May 2011–May 2012)



Again, these observations are consistent with other studies. As the Commonwealth Bank stated, “Much of the market movement around a ratings downgrade tends to be in response to the underlying economic environment, rather than the ratings change itself” (2011, p. 1). The impact of a rating announcement on interest rates is much greater in countries below investment-grade, as opposed to investment-grade sovereigns (Cantor & Packer, 1996). Regarding the 2011 downgrades, Commonwealth Bank (2011) and ASB (2011) both stated that the European debt crisis and related concerns about the global economic downturn dominated trends in the money market (Hunter, 2011). Bank of New Zealand economist Tony Alexander said that while “in theory a credit rating downgrade meant slightly higher interest rates...the impact of the downgrade was likely to be ‘lost in the wash’ for mortgage interest rates, with downward pressure on global interest rates (Weir, 2011). Bernard Hickey (2011) commented in

September 2011 that the rating agencies “aren’t really driving what’s happening in credit markets at the moment.” Because of the situation in Europe, New Zealand happened to win the “least ugly competition.” The New Zealand government, in fact, sold a record billion dollars worth of bonds a day before the downgrade.

As this section has argued, the economic dimension of credit rating agencies’ power seems to be overstated. While changes in credit ratings (including changes in outlook) had a short-term impact on both New Zealand’s interest rate and exchange rate, their long-term impact was minimal. Global economic trends seem to be far greater long-term determinants of interest rates and exchange rates than credit ratings. Global economic concerns can out-weigh any change in rating. Financial markets should be seen as disaggregated entities devoid of any collective or uniform interests. Credit ratings do not represent the opinions of financial markets; they are one opinion, among many.

Conclusion

This chapter has argued that New Zealand’s rapid shift from a Keynesian-inspired welfare state to one of the most liberalized economies in the world was not a necessary structural adjustment to the material structures of the global economic system. Rather, it was an internal political project made possible by the government promoting a globalization discourse that generated a belief that there was “no alternative” to the implementation of certain economic policies. This entailed a spatial reimagining of the New Zealand economy, which was now described as being embedded in the global economic system and therefore subject to its dictates. This process entailed the development of a new mode of governance in which the state and the market would work alongside each other: an example being the state’s strategic use of IO recommendations to further domestic political objectives. The final section illustrates the relative insignificance of credit rating changes on economic indicators, and thus further demonstrates the importance of social and political elements of CRAs’ power.

Chapter 8: Lost in Translation

Introduction

The opaque and obscure nature of credit ratings has meant CRAs' judgments are often depoliticized. As Paudyn comments, "the secretive and obscured nature of the rating process...immunizes the act of rating from political debate" (2012, p. 5). Due to the form of the credit rating, it is difficult to expose the seemingly objective nature of the agencies' judgements and the dynamic of uncertainty absorption to critical scrutiny. Paradoxically, the same processes by which credit rating judgements are depoliticised – their heavily quantitative and risk-based nature – has meant they are granted political salience. As this chapter will demonstrate, the obscure, depoliticized and technical nature of credit ratings effectively places them at the centre of political debate. Because the causes of a change in rating are fundamentally ambiguous, at least to the public, politicians often attempt to use the objectivity and expertise associated with credit ratings for strategic political purposes. The highly quantitative nature of the credit ratings process generates the perception of objectivity, whilst rating's opaque nature grants politicians the ability to interpret the "content" or "rationale" behind a rating change.

The key point stressed in this chapter is that CRAs should not necessarily be viewed as an external force constraining government autonomy. Rather, the agencies' power, in large part, is a discursive construct—one that states can actively contribute to and potentially undermine. CRAs' influence in New Zealand politics was not a direct response to global economic forces. Rather, the CRAs provided the National government an opportunistic and experimental means to address some of the tensions embedded in its program of economic restructuring. In order to better understand CRAs' influence on governments, it is necessary to recognize that the totalizing way in which we often describe CRAs' power is, in fact, central to their contemporary influence. By describing CRAs' influence in determinative terms, critics inadvertently reinscribe the very configurations of power they wish to contest. By highlighting the diversity and heterogeneity involved in state-CRAs interactions, the aim is to open up possible spaces of resistance.

Part 1: The 2009 Budget

On the 13th of January 2009, two months after National's electoral victory, S&P placed New Zealand's AA+ rating on negative outlook. This change brought to light questions about National's economic management and the current state of the economy. The reason given for the change in outlook was New Zealand's narrowing economic policy flexibility in light of the country's widening external imbalances, as evidenced by the sizable current account deficit (Underhill, 2009). According to S&P, the high current account deficit (8% of GDP at the time) was being driven by New Zealand's historically low private savings rates and high private sector debt. As S&P's sovereign rating analyst, Kyran Curry, commented:

[T]he next New Zealand budget will, in our view, be a key indicator of the government's intent regarding medium-term expenditure cuts and reprioritizing of policy initiatives. A credible medium-term fiscal plan combined with an easing of New Zealand's external imbalances could result in the ratings stabilizing at the existing levels. Absent of such developments, the foreign currency rating could be lowered. (Hall, 2009)

Following the shift to negative outlook the National government made avoiding a credit downgrade the primary focus of its 2009 budget. The potentially negative effect of a credit downgrade on the government's cost of borrowing became "absolutely central" to framing the budget strategy of the country (Groser, 2009). S&P's policy recommendation of medium-term fiscal consolidation was made to coincide with National's pre-existing neoliberal-inclined program of deficit reduction through cuts in public spending (Roper, 2011). The National government selectively interpreted S&P's recommendations. This is evidenced by National's heavy-handed focus on reducing public spending and the relative disregard shown to correcting the current account deficit and high private sector overseas debt. Medium-term fiscal consolidation was prescribed by S&P as a means to temporarily ease concerns over market confidence; it was not designed as a solution to New Zealand's structural economic imbalances (in Hall, 2009).

Because National was able to creatively align S&P's recommendations with its own policies, in the lead up to the 2009 budget National emphasised the dire consequences of a rating downgrade to the New Zealand public. Because the New Zealand economy requires such "large inflows of private capital" it was "vitally dependent on its credit standing" (Groser, 2009). John Key (2009) related the importance of New Zealand's credit rating to employment: "The No. 1 way to see New Zealanders down the road from their

jobs is if their business cannot be funded...that is what happens when we have a credit downgrade.” A downgrade, National argued, would add 1-2% to the mortgages of homeowners and the government’s cost of borrowing, a claim substantiated by Treasury. The negative outlook meant that “investors see our debt as risky...they fear that we will default” (Douglas, 2009), and a potential downgrade was described in similar terms. As Key argued, “Lenders would no longer see [New Zealand] as a good credit risk, they would be reluctant to lend us money and when they do, they would charge us ever-higher interest rates” (2009b). “People do not lend people money with the intention of seeing it go down a tube,” Groser (2009a) commented.

Contrary to the view that a downgrade to AA from AA+ could mean a potential default, sovereign governments rarely, if ever, default. In 2012 Greece was the first developed country to default in more than sixty years (Paudyn, 2012). The rating agencies themselves have actually stressed that the impact of a downgrade from such high ratings is minuscule. As S&P’s David Beers points out, “People’s perception is that a downgrade from AAA to AA means minutes later you default...in fact it means only a slight increase in long-term default risk” (The Economist, 2010). By definition an AA rating from S&P means “a very strong capacity to meet financial commitments” (S&P, 2013a). This definition is publically available on S&P’s website. Moreover, National’s estimates that a downgrade would lead to higher interest rates of around 1-2% were questionable at best. The 2011 double downgrades were described as increasing interest rates around 0.05 to 0.10%, which “is barely detectable with the range of interest rates the Government pays” (Dominion Post, 2011). Indeed, as Table 7 demonstrates, on the day of S&P’s 2011 downgrade interest rates rose precisely .05%. The divergence between National’s rhetoric surrounding the severity of a downgrade and the rating agencies’ description points to a politically mediating factor. The question of whether National *believed* in its own dire representations of the agencies’ threat was made clear in the following months as National significantly altered the way it described CRAs.

Within academic literature there is little mention of the way in which states can actively contribute to the discursive construction of CRAs’ influence and expertise. Representations of the New Zealand economy as being dependent on its credit rating coincide with what Larner (1997) terms the new imagined

geographies of globalization. The New Zealand economy is no longer understood as a territorially bounded entity in which economy, state and society are coterminous. Rather than being an autonomous and independent unit, the New Zealand economy is described as being embedded in the flows and transactions that together constitute global capitalism. The pursuit of international competitiveness, which is largely achieved by providing a hospitable environment for global capital, is said to be the only available policy response. Abstaining from its duty of social responsibility, the state must act as an enterprise focused on achieving efficiency, productivity, and in this case, a high credit rating.

Given that S&P highlighted the large current account deficit – driven by low private savings and high private debt -- as New Zealand's most significant economic vulnerability and National had declared securing the country's credit rating the "primary focus of the budget" (Key, 2009), the policy response was puzzling. The 2009 budget reduced government spending and the government's operating deficit—getting on top of government debt was "the No. 1 imperative" of the budget (Adams, 2009). As Rod Oram (2009) commented, the prime minister and finance minister said repeatedly that unless they presented an austere budget S&P would downgrade the government's credit rating. Rather than focusing on reducing private debt or raising private savings rates, the budget radically cut savings initiatives by reducing contributions to the New Zealand Superannuation Fund (Young, 2009). Additionally, throughout 2009 and 2010 National consistently used the threat of a credit downgrade to criticise Labour's proposed spending initiatives. A strategy that involved spending at the rate proposed by Labour meant that New Zealand would "almost certainly" face a downgrade (English, 2009). Credit ratings were used to contribute to a redefinition of the state away from the provision of welfare and social security, which no longer appear as a vital part of economic governance, and towards the state as a "hands-off" facilitator of private enterprise.

The National government's discursive construction of the rating threat successfully generated an apathetic submission to global economic forces within domestic civil society, and thus, by definition, National's policies. As Vernon Small commented (2009), "As a small...country in global markets where capital is increasingly mobile, New Zealand's ongoing competitiveness is reliant on the government maintaining its strong credit rating." The recent budget, Gould (2009) argued, illustrates how we have

become “powerless to decide our own destiny.” Because of the size of New Zealand’s foreign debt our country is “dangerously dependent on the willingness of others to lend us money” (Gould, 2009). According to another commentator, the budget was a “beauty pageant with Standard and Poor’s and Moody’s as the judges” (Fallow, 2009). Thus, due to New Zealand’s place in a global economic system defined by the mobility of capital, the government’s policies were said to be determined by, or at least reliant upon, private actors. National’s culpability for implementing the *necessary* deficit-reduction policies was therefore diminished. As Bernard Hickey (2009) commented after the budget was released, “Standard and Poor’s shocked the new National-led coalition government into a budget tightening when it warned of a potential downgrade in January.”

The focus on securing New Zealand’s credit rating in the 2009 budget was strongly criticized by the Labour party. S&P had received an advanced briefing on the budget by Bill English and the Treasury prior to its public release (Young, 2009a). Using this as its focal point, the Labour party criticized National for “bowing to the whims” of the international rating agencies and neglecting the needs of New Zealanders. As Goff (2009) asked, “Are [we] going to allow the rating agencies to determine what is in a Budget that is meant to be for New Zealanders?” The Government was taking its instructions from people who only saw one dimension of the economy (Goff, 2009a) – the Labour party still made the distinction between economic and social performance indicators. Questions were also raised concerning the historical accuracy of the rating agencies given the recent events of the Subprime Crisis. As Labour’s Parekura Horomia (2009) commented, “If [S&P] is what John Key has hinged this Budget on, then God help us, because this is the same organisation that sent Fannie Mae down.”

Rod Oram (2009) asked a question that many had overlooked: is the threat of a credit downgrade real? And if it were to happen would it have such a significant effect? The threat of a rating downgrade, he argues, was exaggerated for domestic political purposes. A reporter for *The Standard* also commented that there was never any “real threat” of a credit rating downgrade as long as the tax cuts were dropped (Zetetic, 2009). Nonetheless, mainstream New Zealand media acted like there was a huge threat, “they

parroted the government's line that the Budget had to avoid this non-existent threat at all costs [and] then praised the government for seeing off the bogeyman" (Zetetic, 2009).

John Whitehead, the Secretary to the Treasury, can be accused of making such an exaggeration. In his speech "Looking to, and through, Budget 2009," he compared New Zealand with Ireland in order to demonstrate how the market would react to a rating change: "Based on Ireland's recent experience of a credit downgrade, [a rating downgrade] would result in a 1.5% rise in interest rates in New Zealand" (Whitehead, 2009, p. 6). Anyone familiar with Ireland's precarious economic situation at the time would question the reasonableness of this comparison. Oram, for example, argued that:

By invoking Ireland, and in such emotive language, Treasury sounds like a stooge of the government. Yet, as Moody's analysis shows, we are far from another Ireland waiting to happen. We have none of Ireland's problems. For example, its banks blew out their assets to six times GDP and so they need tax-funded rescue. [By] hiding behind the skirts of S&P, the government is dodging the debate about what is good and bad spending. (Oram, 2009)

The short-term focus on securing New Zealand's credit rating allowed the National government to make cuts to government spending with little political debate and sideline questions surrounding how it was going to improve the country's economic performance. Writing for *The Herald*, John Armstrong (2009a) argued that National has used the pretext of satisfying the rating agencies as cover for the contraction of the state. As Phil Goff also commented, "The government is exaggerating the threat of the rating downgrade in order to soften up the public for spending cuts" (Llewellyn, 2009). Fran O'Sullivan (2009), also writing for *The Herald*, argued that the government has used S&P as its "bogeyman" ever since the agency put New Zealand on notice; this is a role, she argues, that CRAs are increasingly playing worldwide. Governments are taking advantage of the "practical utility" of having an outsider tell the public that unpalatable policies are necessary, and thereby reducing the potential political backlash that would occur if politicians had delivered the message (O'Sullivan, 2009). External sources of economic advice are not subject to the same constraints as those coming from internal elite sources, they can "'tell it how it is', with no equivocation or qualification" (Sinclair, 1997, p. 14).

Immediately prior the release of the 2009 budget the National government maintained reservations about a potentially politically disastrous rating downgrade. If the budget did not achieve what it set out to do it would have been a public-relations disaster for National (Armstrong, 2009a). Consequently, National party members temporarily invoked the idea that credit ratings were opinions and that National would do what was best for New Zealand. A day before the release of the budget Bill English (2009a) stated that, “The Government has set out to make the best decisions for New Zealand, according to our own judgment. The rating agencies will continue to form opinions on the result of our decisions.” The shift from credit ratings as objective indicators of performance to mere opinions illustrates how the CRAs’ expertise is used by governments in a highly selective and strategic way.

Following the release of the budget on the 28th of May, S&P shifted New Zealand’s rating back to a stable outlook. The change reflected S&P’s view that the measures announced in the budget would support stabilization of the government’s fiscal position over the medium-term (Daniels, 2009). As National managed to avoid a credit downgrade they shifted back towards describing credit ratings in authoritative terms. The stable outlook was used to demonstrate the success of National’s budget (Peachey, 2009). David Bennett (2009) described the change in outlook as an “international success,” and along with a number of other National party members, misleadingly termed the change in outlook a “credit upgrade.”

National justified its focus on New Zealand’s credit ratings as financial common sense and described alternative views, which downplayed the significance of credit ratings, as straying from basic economic logic. As National’s Amy Adams (2009) argued, “Labour members demonstrate a clear lack of financial understanding when they suggest that ensuring we were not downgraded was unimportant”; the 2009 budget “ensured New Zealand is taken off negative watch and secured our position in the international funding markets, which is, to anyone who understands the basic principles of economics, fundamentally important at this time” (Adams, 2009a). Rather than having a particular opinion within a political debate, those that denied the significance of credit ratings were deemed to lack technical competence. As John Key (2009a) remarked in 2009, “I strongly suggest that the Leader of the Opposition...learn something about economics, and then apologise to the New Zealand public for wanting to ensure that their credit rating was

downgraded.” Simon Power (2009) even described the importance of credit ratings as a fact: “Credit ratings matter to the costs that end up affecting the households of ordinary New Zealanders...This is why it was important for this Government to tell a story in the Budget that...laid out the facts for New Zealanders to enable them to make their own decisions.”

Within this context financial markets are often depicted as homogenous entities whose will coincides with the views of the rating agencies. As Whitehead stated, “financial markets are looking for a Budget that curbs spending and offers a credible plan to rein in runaway government debt” (in Fallow, 2009a). The material reality of capital mobility is described as allowing financial markets, in this case CRAs, to determine government policy. As Sinclair and Chwioroth argue, international capital mobility is often problematically presented as a “brute observational fact -- one which possesses an unproblematic, uniform, and necessitarian logic to which actors respond automatically across time and space” (2012, p. 1). Capital mobility, the authors argue, should not be seen as a material reality, but a social fact, one that must be constructed. A point all the more valid given the insignificance of rating changes to the government’s bond yields. There is thus a need, as Chwioroth and Sinclair (2012) argue, for more agent-centered and strategic analysis of the social and discursive processes that underpin capital mobility.

National’s discursive construction of CRAs’ power is an example of an agent strategically constructing the social and discursive foundations of capital mobility and, paradoxically enough, its influence over states, or at least the perception thereof. Simply because a discourse espouses private authority as an authoritative component of the international system, it should not be assumed to be constructed by a private actor. In the New Zealand setting, the National government played an instrumental role in constructing the power and expertise of the CRAs, which simultaneously fortified their policy autonomy over domestic social forces and reinforced the agencies’ expertise. Priebe argues that CRAs are “in a far more powerful position than the sovereign state. The hierarchy of knowledge is all too clear...states play a subordinated role in the knowledge generation process” (2012, p. 108). Priebe incorrectly assumes an inherently antagonistic relationship between the two entities, and thus misses how they can potentially work together, strengthening both states’ autonomy and the agencies’ expertise.

This process can be viewed as a form of rollout neoliberalism as the principal aim is to have economic policies represented as technical and thus removed from political debate. The grounding of authority in a claim to scientificity and objectivity “establishes in a unique way the distance between systems of self-regulation and the formal organs of political power” (Rose, 1998, p. 156). This distance allowed the government to govern “at a distance” and generate the commonsensical nature of such policies. The formation and organization of consent within the sphere of civil society is central to the act of governing (Fontana, 2006). Using experts within civil society, like the CRAs, offers a means by which consent can be generated. The material and moral strength of the state, Fontana (2006) argues, depends precisely upon its ability to assimilate the cultural and ideological activity taking place within civil society in order to transform it into legitimate support. This is precisely what the National government sought to achieve when it drew support from the rating agencies to legitimize its policies.

Part 2: The Limits of Interpretation

The centrality of credit ratings to National’s strategy of economic management strategy soon temporarily diminished. On the 16th of July 2009, Fitch placed New Zealand’s AA+ rating on negative outlook. This reflected the agency’s concern over New Zealand’s medium-term growth outlook given its persistently large current account deficit, rising foreign indebtedness and low household savings (Hickey, 2009). If New Zealand’s net external liabilities were not reduced it could have a perverse affect on New Zealand’s strong public finances. While reducing net external debt and increasing household savings were the primary policy recommendations, their potential insufficiency warranted fiscal prudence and public savings as alleviatory measures. As Fitch stated:

[T]here is a risk that the required balance sheet adjustment by households and, more generally the private sector, will be insufficient in reducing the current account deficit and foreign indebtedness to a more sustainable and safe level...Against this backdrop of external vulnerability, more aggressive restoration of public finances through fiscal prudence will be needed to raise the national savings rate to counter weak private savings. (in Hickey, 2009)

Due to the centrality that National placed on maintaining New Zealand’s credit rating, Labour was quick to use this as an illustration of National’s economic mismanagement and its inability to follow the

advice of the rating agencies. National's policies of cutting Kiwisaver and superannuation contributions worsened New Zealand's poor household savings rates, which S&P had previously highlighted as a vulnerability, and resulted in Fitch shifting NZ's rating to negative outlook. As Cunliffe (2009a) argued, reducing government spending was meant to "offset" low private saving and high debt, but "it [was] a patch, not a resolution to the fundamental problem." The government's overwhelming focus on reducing public spending was seen as problematic. Bryan Gould (2009) questioned National's "obsession" with government debt given that S&P had said that the government was in a relatively healthy debt position. Cunliffe (2009a) asked why, if Moody's had rated New Zealand as having only a "limited debt challenge," had Bill English been "attempting to scare New Zealanders into accepting his Government's contractionary policies?"

National responded by describing Fitch as a "much smaller player" than S&P and thus much less significant (Key, 2009). Key (2009a) argued that if the government had followed Labour's proposed budget New Zealand would have been "downgraded by every single rating agency." In contrast to his previous position, Key (2009a) claimed that he could not "understand the leader of the Opposition's fixation with the rating agencies at the moment." National claimed that the causes of the rating change were external to both the New Zealand economy and its current management.⁶² Because Ireland's banking crisis had reached dire levels, international investors were said to be more sensitive to the debt burdens of small economies (English, 2010). The issues raised by S&P, English argued, "are already being focused on by the government" (Tarrant, 2010).

Things continued to deteriorate for the National party. On the 22nd of November 2010, S&P also placed New Zealand on negative outlook. S&P cited concerns over the amount of debt built up in the private sector, particularly by local banks: "The outlook revision on the foreign currency ratings reflect our recognition of the risks stemming from New Zealand's projected widening external imbalances," said Kyran Curry (NZPA, 2010). Curry went on to say that if the external liabilities of the banks continued to grow it doesn't matter how "strong the balance sheet of the Government might be", it will become a problem

⁶² As Bill English argued, "Nothing material has changed from the point of view of an external credit rating. Actually we think it's better; what has changed [is] the external situation" (Tarrant, 2010a).

(Bennett, 2010). New Zealand's fiscal and monetary flexibility were said to be in good shape. High private sector debt was the determining factor for the change in outlook. S&P noted that increasing government savings offered a means to offset external imbalances and reduce any further downward pressure on New Zealand's sovereign rating (NBR staff, 2010). S&P's and Fitch's view that increasing government savings can offset high private sector external debt illustrates the influence of neo-classical economics on their judgements. More heterodox economists argue that lowering government spending will actually worsen private sector debt (Keen, 2011).

Irrespective of S&P's statements, the causes of the change in outlook were hotly debated among politicians, sparking a blame game between National and Labour as to what led S&P to make this "surprise move" (Tarrant, 2010). Brendan O'Donovan, a Westpac economist, described the change as "perplexing" given the recent shrinking of New Zealand's current account deficit and lower household debt levels (Weir, 2010). The fact that the cause of the rating change is debatable is crucial to how governments are granted a *degree of flexibility* when interpreting a rating change and the necessary policy response.

Despite this attempt to externalize the crisis, the shift to negative outlook again highlighted certain contradictions between S&P's recommendations and the policies implemented by the National government. National, Labour argued, failed to adequately address the problems of low private savings and high private external debt: "All three rating agencies drew particular attention to two deficits—the savings deficit and the external deficit...In that context, it really does beggar belief [*sic*] ...that the Government would withdraw half of the value of the incentives in the KiwiSaver programme—the single most successful programme in our history for getting New Zealand's savings rate up" (Cunliffe, 2010). The obvious contradiction, which Cunliffe, among others, highlighted, represents the limits of National ability to interpret a rating change. These contradictions pointed out by both the New Zealand media and opposition parties attest to the inconsistent and often contradictory way in the agencies' expertise was invoked for political purposes.

Part 3: Double Downgrade Day

Prior to the release of the 2011 budget a debate ensued concerning how to stimulate economic growth. Within this debate National consistently rejected proposals to increase government spending due to the need to avoid a rating downgrade. As Key (2011b) argued, borrowing to stimulate economic growth “will not be acceptable to the rating agencies.” Chris Auchinvole also (2011) claimed, “a major risk of not bringing our debt under control is the risk of a credit downgrade. Standard and Poor’s has New Zealand on negative outlook as we speak.” Again, National emphasized the dire importance of New Zealand’s credit ratings, albeit while distorting the agencies’ focus on high private debt and low private savings. This was evidenced by the content of the budget, which included no new government spending, sizeable cuts to KiwiSaver and Working for Families, a reduction in the size of the state sector and the partial privatization of some state-owned assets (SOEs) (Hunter & Chapman, 2011). The focus remained largely on reducing the size of the government’s operating deficit. Because NZ’s rating remained unchanged after the budgets release, John Key (2011) claimed, “Phil Goff might not like this budget, but Standard and Poor’s does...it has just given this budget the tick.”

Brian Easton (2011) described the 2011 budget as a wedding and “outside were the credit rating agencies...with their shotguns unloaded as long as expenses were kept down.” Following the successful avoidance of a rating downgrade, Hunter and Chapman (2011) stated that New Zealand’s credit rating was now “safe” as the government had “done enough to keep debt under control.” One commentator even described National’s budget as “S&P’s budget” (Watkin, 2011). A reporter for the *Dominion Post* commented that S&P will be “pleased” with the budget’s expenditure cuts (Maharey, 2011). In terms of public opinion, there was little reaction to the spending cuts. National was able to successfully co-construct the threat of a rating downgrade to generate docility and apathy among the New Zealand public by externalizing the necessitarian logic of deficit reduction. After three years of being told that there was “no alternative,” voters “feel they should quietly take their medicine” (Maharey, 2011).

Despite both S&P and Fitch stating that raising private saving rates was an essential component to avoiding future downgrades, the budget nonetheless cut government contributions to KiwiSaver in half

(totalling \$650 million), forcing the private sector to make up the difference (Nippert, 2011). Phil Goff (2011) asked, “Why, when the Budget was meant to be about savings, has the government cut savings...Even Standard and Poor’s says that that policy...will risk damaging New Zealand by pushing it further into debt.” National’s focus on the need for deficit reduction was contradicted by the agencies. Moody’s analyst Stephen Hass commented that the deficit and debt trajectories of the government were “exactly what one would hope and compatible with the rating we have” (Fallon, 2011). S&P’s Kyran Curry stated that New Zealand’s public debt was only half the median level for an AA-rated sovereign (Fallon, 2011). As Curry told *The Herald*, unlike Key, S&P did not believe that the state sector was bloated and inefficient: “We look at the Government in New Zealand as being relatively small and compared to its peers it’s quite efficient” (Bennett, 2011).

Five months after the release of the budget both Fitch and S&P downgraded New Zealand’s sovereign credit ratings to AA from AA+. The last time New Zealand’s sovereign rating was downgraded was in 1998, over thirteen years ago. The downgrade consequently sparked considerable debate within parliament and civil society regarding both the possible causes of, and responses to, the rating change. Fitch and S&P stated that the primary cause of the downgrades were NZ’s high net external liabilities, as driven by high private sector debt and low private savings. NZ’s weakened fiscal position as a result of the Christchurch earthquake was also briefly mentioned alongside the volatile international environment (Hickey & Tarrant, 2011). The New Zealand government, S&P noted, continued to enjoy plenty of monetary and fiscal flexibility: “While New Zealand’s public sector finances are not strained, private-sector balance sheets--particularly in the banking system--carry a high level of external liabilities.” For Fitch, New Zealand’s creditworthiness was “supported by moderate public indebtedness and fiscal prudence” (Commonwealth Bank, 2011). Debt levels in households and the agriculture sectors were by contrast noticeably high (Wassener, 2011).⁶³ As Curry commented, “Upward pressure on the ratings could emerge if sustained

⁶³ To put this in perspective, the New Zealand government’s debt-to-GDP ratio was 32.3% in 2011, compared to an OECD average of 72.8% (Blommestein, Keskinler & Flores, 2012). Additionally, the government’s gross overseas debt has fallen from 26% of GDP to below 10% prior to the Global Financial Crisis, and net private debt has risen to 115% of GDP in 2010 from 46% in 1989 (Steenkamp, 2010). Thus, comparatively speaking, neither the government debt nor its overseas borrowing is out of control -- private debt, however, remains high.

current account surpluses, led by a stronger export performance...markedly reduced external debt" (Bridgeman & Bond, 2011).

Following the double downgrade a heated debate ensued surrounding the primary cause of the downgrades. Due to the complexity of the judgement and the opaque nature of the rating process itself the causes of the downgrade were unclear. As Westpac Chief Economist Dominick Stephens noted, it is "difficult to know what new information provided the catalyst for Fitch to shift from negative outlook to take the decision to downgrade" (NZ Herald Staff, 2011). While some commentators pointed towards the fiscal stress associated with earthquake-related spending, Annette Beacher, head of research at TD Securities, described this as a "questionable trigger" (Bridgeman & Bond, 2011).

Bill English was quick to proclaim that the downgrades were the result of external events in Europe. The volatile nature of the European financial markets, due to the ongoing sovereign debt crisis, was said to be the primary cause. The rating agencies, English argued, are becoming more sensitive as "the global economy is facing increased volatility and lower growth prospects" (English, 2011), producing a more conservative investment climate (3 News, 2011). As English explained, one rating agency executive had told him that they had been caught out by not giving enough weight to Italy's external debt; as a result, every sovereign has now come "under the microscope" (Hickey & Tarrant, 2011).

In an effort to downplay the significance of the rating changes, the National government also drew on a nationalistic sentiment and emphasized the subjective nature of credit ratings. As Bill English stated, "We're not run by the rating agencies...we do what we believe is the best thing for the New Zealand economy...and they have an opinion about it" (in Hartvelt, 2011). This nationalistic sentiment refers to the sovereignty status of New Zealand; it idealizes policy-makers' espoused ability to govern independently from outside influence. Sovereignty here is not a brute fact, but a political discourse being used to delegitimize the idea of a private company influencing government policy. The idea that "we're not run by

the agencies” deliberately constructs a negative connotation surrounding any influence that the rating agencies could have on government policy. English (2011) later commented, “We do not run the country for the rating agencies. What we do is make the best decisions, we believe, for the benefit of the New Zealand economy, and the rating agencies are free to form their opinions about that.” These comments differ significantly from the statements made in 2009; previously, “anyone who understands the basic principles of economics” should appreciate the fundamental necessity of maintaining a high credit rating.

The selective way in which the National party described credit ratings illustrates governments' roles in interpreting rating changes. The National government not only highlighted certain policies recommended by the agencies and neglected others, it has also selectively evoked a globalist and a nationalist discourse in an effort to either increase or decrease the authority granted to the rating agencies. Thus, neither the 2009 nor 2011 budgets, which were supposedly designed to placate the rating agencies, are examples of private powers influencing government policy, but are examples of the government using the expertise and authority associated with a private actor to justify the implementation of its preferred economic policies.

One could argue that this merely illustrates how politicians use anything at their disposal to achieve political goals. Such a view, however, fails to grasp the extent to which certain private actors are granted a hegemonic position as knowledge producers in the international arena. As Gill argues, private power gains a hegemonic status when policies are “adopted with little reflection on, or realistically, belief in, the possibility of alternatives” (2008, p. 54). Sinclair refines this assertion in relation to CRAs, which, he argues, constrain “thinking to a specific range of acceptable possibilities” that guide decision makers (2001, p. 443). The discontinuous nature of National’s description of credit ratings, and the fact that National did not follow major elements of the agencies’ advice, suggests that they do not genuinely believe in the expertise of the rating agencies, but are merely interested in the expert authority they wield.

Elements of the New Zealand media seemed to side with the rating agencies' condemnation of National's economic management, often confusing credit ratings with objective indicators of performance. The continued importance attached to credit ratings within civil society, despite the fact that National attempted to diminish their relevance, illustrates that National cannot simply govern through political manipulation. Rather, the agencies' intersubjective expertise, which National took a part in creating, gained a life of its own, reformulating the political-economic identities of New Zealanders in diverse and variegated ways. Bernard Hickey (2011), a reporter for *The New Zealand Herald*, argued that following the downgrade "some cold hard facts splashed in [John Key's] face...the rating agencies are telling him he has not done enough to turn around the New Zealand ship." Armstrong (2011) also commented that the downgrades had "cast a big shadow over National's claim to be the most competent manager of the economy," and was a huge "psychological fillip" for Labour who was desperate to realign the debate on economic management.

This, however, was only part of the story. Following the downgrades National was generally successful at externalizing the causes of the downgrade, and was able to use the rating change as a means to reinforce the necessity of pre-existing policies. Here the idea of crisis as governance comes to the forefront; even when economic crises highlight certain contradictions within existing policies, the discursive and metaphorical representation of the crises can act as indirect mechanisms of governance, re-legitimizing pre-existing relations of authority and market processes (Brassett & Vaughan-Williams, 2012). Metaphorical representations of crises seek to draw upon familiar themes and through them justify both policy responses and the legitimacy of ruling elites (Kelly, 2001, p. 720). Crisis as governance is often achieved by externalizing the causes of economic crises; thus, the statements made by John Key and Bill English, which argue that any negative changes in New Zealand's rating is the result of external forces, are potent examples. The 2011 downgrade was depicted as weathering the global financial storm that has been created by the European debt crisis. One reporter from *The Waikato Times* remarked that the New Zealand downgrades were caused by the storm clouds "getting much darker in Europe." The rating agencies, he argued, are more worried about how the rest of the world's financial problems will affect New Zealand (Weir, 2011).

By externalizing the causes of the downgrades National was able to maintain public support. As an article in *The Herald* observed, “Half of those surveyed in a poll this week attributed credit downgrades by the rating agencies to international turmoil and the Christchurch earthquakes, not Beehive ineptitude” (NZ Herald, 2011). National was not widely criticized for its handling of the economy, as its polling numbers remained at record levels. National’s crucial strength, as Tim Watkin (2011a) noted, “Is that voters don’t blame them for their economic woes. While the world looks [like] such a mess, it’s been easy to deflect that elsewhere.” Voters did not seem to think there was a problem to solve: “National...skilfully played to that mood by saying New Zealand was better placed than most countries to ride out - or muddle through...any international downturn resulting from European and American debt crises” (Armstrong, 2011). As negative rating changes are described as being caused by global economic conditions, the problematic elements of government policies are removed from view.

The market’s reaction to the double downgrades was also highly debated. Bill English (2011) argued while “conventional wisdom” dictated that a lower credit rating would lead to higher interest rates, “on the other hand interest rates around the world are still going down and in New Zealand they are at a 45 year low.” In fact, as English pointed out, the day prior to the downgrade New Zealand sold a billion dollars worth of government bonds at record low interest rates. This was said to occur because New Zealand was the least ugly global investment given the financial situation occurring in Europe. English here adopts a disaggregated view of financial markets where markets are seen as comprising a multiplicity of component parts and opinions, and CRAs represent one opinion among many. CRAs’ influence on governments’ borrowing cost is situated within global economic trends. Alternative investment opportunities, as English argued at the time, had a greater influence than the rating agencies in this case (Small, 2011).

The government’s response to the downgrades was to stick to the plan. As English commented, the government has to implement “more of that plan that we’ve got in place and getting the Government back to surplus is going to mean a real squeeze on the public services over the next two or three years” (Small, 2011). The ratings news, English argued, reinforces the need for the government to continue with austerity

measures. English, with very little specificity, claimed that, “The fundamental policies we’ve got in place are credible. They’ve been effectively endorsed by the rating agencies” (NBR Staff, 2011). The policy recommendations by the rating agencies do not differ from National’s pre-existing policies, the difference, National argued, lies only in levels of optimism regarding policy outcomes: “We’re pretty positive about the plans. They’re a bit less optimistic” (NBR Staff, 2011). Given that S&P and Fitch both stated that reducing the government’s deficit was only an alleviatory response, National’s response to the downgrades is a good example of political appropriation. Thus, a rating downgrade does not necessarily erode governments’ decision-making autonomy, but can also present an opportunity. Because New Zealand’s debt problem and poor global economic conditions were familiar themes to the New Zealand public, by drawing on these National not only avoided questions surrounding its economic management, but also reinforced deficit reduction as the only solution to New Zealand’s economic woes.

National continued to use the fear of a credit downgrade as justification for the government’s policies, particularly reducing the government’s deficit: “We believe if we get back to surplus...and start paying off the mountain of debt we have, we would tend to have rating agencies view us more favourably” (English, 2011a). National’s interpretation of the rating agencies’ judgements have been particularly successful. It has become common sense to associate an increase in government spending with the possibility of a rating downgrade. As an example, in a recent debate on Radio National (2012) concerning the increasing cost of public health care in New Zealand, one commentator argued, New Zealand can either reduce public spending on healthcare, or Standard and Poor’s will “tell us to do it.” This process further reified the agencies’ expertise. As Joyce (2012a) commented in 2012, “The reality is if you look at the commentators who count—for example, Standard and Poor’s and those rating agencies—they have all endorsed the New Zealand Budget...as have a number of other serious economic commentators.” Joyce contrasts the subjective opinions of journalist with the rating agencies who are “serious economic commentators” whose opinions carry more weight.

The New Zealand case is a clear example in which the need to avoid a rating downgrade was used by politicians to narrow the range of legitimate policy options. National Party members used negative rating

changes, and the threat thereof, to create a crisis over the size of the budget deficit. The act of making a crisis out of budget deficits is used to generate external sources of fiscal and general policy discipline (Sinclair, 1997). States actively seek to generate the perception of a deficit crisis in order to depoliticize policy making and artificially subject policy to the so-called whims of the market. Similar to the New Zealand story, Sinclair describes a bizarre situation in Toronto in which financial market elites, from both the public and private sector, sought a downgrade of Canada's sovereign rating in order to reinforce market discipline: "Rather than wanting to see governments escape external constraints to a world of autonomy, globalizing elites are actually endeavouring to terminate national policy autonomy by attracting these sort of negative judgements" (Sinclair, 1997, p. 14).

The constant use of the rating agencies as justification for fiscal prudence is an example of the government and a private actor co-constructing a deficit discourse—a hegemonic construct that identifies the reduction of government deficits as the principal means to increase economic growth and national competitiveness. Deficit discourse places low to minimal value on government activities as a means of wealth-creation, and as a result "operates as a way, mentally and in practice, of closing sets of practices off from contestation, or at least gradually narrowing the parameters of the public debate in ways that sustain a globalizing hegemony" (Sinclair, 1997, p. 2). This can be seen in the constant rejection of Labour's proposed spending initiatives due to the threat of a downgrade. As the CRAs have promoted the reduction of government debt as a short-term solution, they too are complicit in the construction of this discourse, which is neither fully private nor public.

Credit rating agencies are commonly said to be purveyors of neoliberal economic orthodoxy. Their judgements are thus often assumed to strengthen the position of globalizing elites seeking to implement neoliberal economic policies. While neoliberalism in New Zealand is characteristic of Third-Way politics -- that is, due to the normalization of neoliberalism in New Zealand both Labour and National can be seen as neoliberal -- the National party represents a more orthodox stance. As such, CRAs' judgements should strengthen National's position in domestic politics; however, in the New Zealand case, while the National party was able to use the credit ratings to reinforce their policies, so were opposition parties. An interesting

feature of the political debates which followed the 2011 downgrades was the opposition parties' consistent and systematic use of the rating change as a means to argue for alternative, less neoliberal economic policies. This was within the degrees of interpretation set by the rating agencies, but nonetheless required elements of extrapolation only made possible by the characteristics of credit ratings.

The assumption that the agencies reinforce a uniform set of neoliberal economic policies grants their judgements a level of transparency that is quickly negated through even a cursory glance at the rating form and the agencies' judgmental process. The representations of financial markets in general, and CRAs in particular, as "homogenous and clearly bounded system[s]," which unproblematically disperse their power and expertise in a way that erodes governmental autonomy, attributes to the power of such institutions "a degree of effectiveness and autonomy that seems impossible to refute" (de Goede, 2005, p. 149).

As an example of the interpretable nature of a rating change, throughout 2011 National's asset sales policies were criticized by opposition parties who cited the fact that the rating agencies had criticized New Zealand for its widening current account deficit. Bill English (2011b) argued, "from the point of view of the rating agencies, the alternative (borrowing) is significantly worse." In response, Phil Goff (2011) stated, "the rating agencies would look far more positively on a situation where you have an ongoing source of revenue, not a one-off sale by the disposal of assets" (Tarrant, 2011). Similarly, Clayton Cosgrove (2011) argued, "In light of Standard and Poor's comments that 'downward pressure on New Zealand's ratings could re-emerge if New Zealand's external position continued to deteriorate', why will [National] not reverse [its] asset sales policy, given that it will inevitably worsen our external position when dividends begin to flow offshore?" Green Party leader Russel Norman was the strongest advocate for this position. The privatization of State Owned Assets (SOAs), Norman argued, inevitably leads to significant levels of foreign ownership, producing a growing current account deficit as profits continue to be shipped offshore:

The primary reason for the [2011] downgrade was a worsening outlook for New Zealand's current account deficit due largely to high levels of foreign ownership...privatizing our state-owned enterprises, which will inevitably lead to significant overseas ownership of them, will worsen the current account deficit as even greater levels of profits will flow offshore to their new owners...we can solve this by retaining ownership of our state-owned enterprises. (Hickey & Tan, 2011)

These arguments made by Goff, Cosgrove and Norman illustrate the possibility that the expertise of CRAs can be used to resist the imposition of certain orthodox economic policies, in this case privatization. The downgrades handed “Key’s opponents a useful weapon to challenge his Government’s economic management” (O’Sullivan, 2011). The transfer of rating orthodoxy is typically seen as a linear process devoid of local political influence; this gives a largely decontextualized and inaccurate depiction of CRAs’ ability to transfer policy orthodoxy. Despite advocating divergent policies these politicians claim to be describing the preferences of the rating agencies without obvious contradiction. This attests to the opaque and interpretable nature of the agencies’ recommendations. While National was generally more successful than its opponents at using the credit ratings for domestic political purposes, the fact that there was a debate regarding the causes of, and responses to, the credit rating changes is a significant historical detail that should not be overlooked.

Conclusion

This chapter sought to examine the power of CRAs and their influence on governments from a transformationalist perspective. In discussing the interactions that occurred between the New Zealand government and the CRAs between 2008 and 2012, the widespread idea that negative rating judgements erode national sovereignty and governments’ scope for domestic policy intervention was questioned. As National’s actions made clear, governments are able to, at times, use credit ratings to justify the implementation of domestically unpopular policies. As noted in the literature on neoliberalism, the state plays a positive role in the construction and continuation of market-based forms of economic governance. Credit ratings have the greatest influence when their recommendations align with pre-existing domestic policy agendas. If not, they can get lost in translation as the government externalizes the causes for the downgrade and espouses the subjective component involved in credit rating. Consequently, the influence of CRAs is much more context-specific and state-dependent than previously assumed. States play an important role in the discursive construction of CRAs’ authority, which is therefore neither fully private nor public.

Chapter 9: Conclusion

In writing this thesis I sought to answer two interrelated questions: what is the source of CRAs' power? And how do CRAs constrain the policy autonomy of governments? In seeking to answer these questions, the dominant theoretical approaches to power in the international political economy were explored. State-market interactions have traditionally been viewed in largely dichotomized and antagonistic terms. This is captured by the polarized nature of the globalization debate between the structuralists and sceptics. The theoretical assumptions embedded in this debate have set the terms of debate regarding how we view CRAs' influence over governments. There are two traditional theoretical approaches to theorizing the relationship between states and CRAs. The first, drawing from the structuralist theoretical tradition, is the reputation school, which argues that CRAs' power is a private construction that erodes the decision-making autonomy of governments. The second, and coinciding with the sceptics' perspective, is the regulation school that argues CRAs' power is the result of the state incorporating credit ratings into market regulations, specifically the US state. CRAs' power is said to represent a manifestation of US state power and interests and serves to erode the decision-making autonomy of other states, subjecting them to US regulatory standards. Both approaches therefore, generally speaking, share the assumption that CRAs erode government autonomy.

Both of these perspectives were found wanting. The reputation school's exclusive focus on CRAs' power as a private construction insufficiently recognizes the instrumental role played by the US state in empowering these corporations. The disproportionate influence of Moody's, S&P and Fitch – accounting for some 95% of market share for all ratings and 99% for sovereign ratings – cannot be sufficiently explained without reference to the Securities and Exchange Commission granting these agencies NRSRO status in 1975. Moreover, the regulation school is unable to explain why on a number of occasions, despite a lack of regulatory pressure, private actors have sought credit ratings. This is most easily seen in the general market practice of acquiring two or three ratings despite regulations requiring only one, and in the practice of governments who seek a rating with no intention of issuing securities in the bond market.

The failure of these two perspectives incited the need for a new approach and thus *transformationalism* was put forward. Transformationalists highlight how the state is neither being eroded by global economic forces nor has it remained unchanged. Rather, the state has transformed; it has developed new methods of indirect governance, which govern in conjunction with the market and private actors. By abandoning the state-market, public-private and national-global dichotomies embedded in the structuralist-sceptics debate, and the zero-sum mentality they are predicated upon, this view offered an alternative lens from which to view the power and influence of CRAs. By abandoning the zero-sum mentality of the structuralist-sceptics debate, CRAs' power can be seen as a distinct hybrid representing a complex intermeshing of public-private, state-market and the global and the national spheres. CRAs' influence over governments therefore becomes much more indeterminate.

Because CRAs' power is the outcome of both state and private power, their influence on national sovereignty is much more complex, changing, and context-specific than previously acknowledged. State-market relations are seen as an interaction, which is both potentially cooperative and conflictual. States and markets are not seen as mutually exclusive and antagonistic entities: why should new interactions between public and private entities necessarily be more or less enabling for the policy autonomy of governments in general? While newly powerful private entities can and have been antagonistic to governments' autonomy, such an observation should not limit our scope for theoretical inquiry. The apparent misalignment between the state and global economy relies on a spatial fixing of power and influence of nation-states. Sovereignty today, however, is much more complex; it is less exclusive and internally hierarchical, and more diverse. The state, and the ways it governs, has radically changed. It now consists of a highly heterogeneous network of organizations and partnerships, many of which enjoy significant levels of autonomy from elected politicians. The traditional public-private distinction, which previously analysis was hinged upon, has thus become considerably blurred.

Transformationalism abandons the artificial distinction between the social, economic and political spheres. CRAs' power can therefore be seen as a result of an interpenetration of these spheres, as opposed

to an independent outcome of one of them, as in traditional accounts. Focusing on the economic component, Chapter 3 highlighted how financial globalization has heightened the need for CRAs. The liberalization and deregulation of national financial centres that commenced in the 1970s triggered a massive growth of global financial markets and produced a radical restructuring of domestic banking and financial industries. Securitization and disintermediation have reduced the role of banks as financial intermediaries and heightened the complexity and volatility of financial markets. By providing judgements on financial risk, CRAs emerge to fill the gap left by banks by acting as an informational intermediary between the suppliers and users of capital.

While such changes have heightened the need for various institutions of credit evaluation, the question of why CRAs have come to dominate this market cannot be sufficiently explained by market trends. As CRAs represent only one among a number of institutions that produce credit-related information, the idea that there is no alternative to CRAs in a disintermediated financial environment is problematic. In an attempt to understand why CRAs have come to dominate the market of credit evaluation, the social and political components of CRAs' power were then explored.

Recognizing the political component of CRAs' power required abandoning the artificial distinction between the state and markets and the assumption of an inherent antagonism between the two. Financial markets require institutional and discursive support, which states provide. States thus regularly intervene in markets, albeit through increasingly indirect means. CRAs' power is not an exclusively private construction, but, by strategically incorporating ratings into financial market regulations, states have been instrumental in empowering CRAs' judgements and giving them de facto legal recognition. Some commentators have subsequently argued that CRAs' power is primarily the result of their regulatory incorporation. Despite implementing legislative measures to reduce the use of credit ratings in market regulations, the total profits of all registered NRSROs went up from \$3.7 billion in 2011 to \$4.2 billion in 2012 (SEC, 2012).

While regulations often stipulate that financial market actors obtain a credit rating, common market practice is that two or three ratings be acquired. Moreover, changes in the sovereign bond market cannot

be explained by reference to ratings-dependent regulation. A number of governments with no intention of issuing debt in bond markets have sought ratings. Indeed, this group is driving the growth in the sovereign rating market. Credit ratings have thus been something that governments have sought out, even promoted. A conception of CRAs' power as simply a coercive regulatory force is therefore inadequate. While we must recognize that states play a role in creating CRAs, this should not lead us to neglect other social and economic dynamics of CRAs' power.

The focus thus shifts to how CRAs have generated socially recognized expertise, a question insufficiently explored by academics. The examples of Japan and Europe were used to criticize Sinclair's notion of embedded knowledge networks. In these cases, while the agencies were clearly seen as imposed entities, they nonetheless held considerable power. In an attempt to further explicate the social dimensions of CRAs' power, the sociology of quantification was drawn upon to emphasize how the form of the credit rating, and the methodology said to underpin it, grant CRAs a privileged position as knowledge producers of credit evaluation. The way in which the agencies shroud ratings in images of quantitative rigor and mathematical precision obscures the subjective nature of their ratings and generates the perception that such techniques can objectively determine financial risk. This creates a situation where market participants often confuse ratings with objective measures of performance. Additionally, as Chapter 6 discusses, because credit ratings are highly simplified expressions of an intricately complex financial, economic and political reality, they therefore contribute to a process of uncertainty absorption: a process in which complexity is replaced with simplicity, subjective uncertainty with objective risk, and political decisions with mechanistic processes dictated by technical criteria. Even if one questioned the agencies' judgments, neither the information on how credit ratings are determined, the data used within the rating process, nor the full commentary accompanying a rating change, would be publically available.

Following an illustration of the role that belief plays in financial markets, the American state's discursive response to the Subprime Crisis was also discussed. This highlighted how states participate in not only the institutional but also the discursive underpinnings of markets. By introducing the notion of crisis as governance the goal was to highlight how, even when economic crises highlight certain contradictions

within existing policies, state-based discursive and metaphorical representations of the crises can act as an indirect mechanism of governance. For example, blaming CRAs for the Subprime Crisis was an effort by the US state to transpose the roots of the crisis from the inherent instability of neoliberalism to a clearly identifiable and fixable actor. By highlighting how states are able to discursively respond to economic crisis so as to maintain pre-existing market apparatuses and state power, the ability of states to potentially use negative credit rating judgments for domestic policy purposes was brought to light.

The unique characteristics of the rating form, specifically the dynamics of uncertainty absorption, and the opaque nature of the method, data and causes of the judgment, have specific consequences for theorizing state-CRA interactions. Due to these dynamics, as the New Zealand case illustrates, rating changes become up for interpretation. New Zealand's political-economic history has contained similar dynamics in times when the New Zealand government, while attempting to further its program of economic restructuring, was able to selectively interpret private actor recommendations. Notions of private power often neglect how the travel of ideas is an active process of social translation. Domestic agents are often active in this process of translation and reflect their own interests in the process. Similarly, those studying CRAs' influence over governments often neglect the way in which ratings are communicated to, and made influential in, domestic settings.

These theoretical observations were applied to New Zealand's interactions with CRAs from 2008 to 2012. Before discussing the socio-political reaction to rating changes, market reactions were first discussed. Focusing on the six changes in New Zealand's credit rating between 2008 and 2012, the relative changes in the NZD and the New Zealand government's bond yields following a rating change were graphed. Both the quantitative research and the academic commentary at the time reinforce the notion that while rating changes have a short-term impact on such indicators, their long-term effect is marginal. Global economic trends were far greater long-term determinants of the government cost of borrowing and the NZD. The relative insignificance of credit rating changes to economic indicators illustrates the importance of social and political components of CRAs' power.

The New Zealand case illustrates how politicians can use credit ratings to reinforce or legitimize their own pre-existing policy agenda. Trust in politicians was replaced by a more socially accepted trust in ratings. Following the 2011 downgrades, National successfully convinced the New Zealand public that the agencies' recommendations coincided with their pre-existing policies. Despite being told by the agencies that New Zealand's most significant macro-economic challenge was its large current account deficit, driven by large private external liabilities and low private savings, the National government used the fear of another negative rating change to reinforce its program of deficit reduction and asset privatization. Because National was able to use the ratings changes for its own purposes, it often aided in co-constructing the expertise and authority of the rating agencies. The outcome of any negative rating change was described by National in dire terms whereby investors were said to fear New Zealand would default on its debt and anyone who did not recognize the significance of NZ's credit ratings was described as being unable to understand basic economics.

Such descriptions are particularly important. Drawing on transformationalists' account of globalization, which emphasizes the problematic nature of the causal materialism embedded in the structuralist-sceptics debate, globalization is described as a discourse – an interpretative schema through which economic relations are understood and constituted. Processes of knowledge, interpretation and description do not exist in secondary importance to real material financial structures, but are precisely the way in which they materialize. The power of CRAs, and globalization more generally, should not solely be understood as resulting from objective economic structures, namely capital mobility. The result of such thinking is an implicit determinism in which CRAs are understood to be part of the new, inescapable financial architecture within which governments must act. Representations of financial markets in general, and CRAs in particular, as “homogenous and clearly bounded system[s]” that unproblematically erode governments' autonomy attributes to the power of financial institutions “a degree of effectiveness and autonomy that seems impossible to refute” (de Goede, 2005, p. 149).

The power of CRAs is generally understood as a materially existing reality to which governments must respond. To critique such logic, the economic impact of changes to New Zealand's credit rating was

demonstrated to be relatively insignificant. This leads to a similar conclusion reached by Larner (1998) about globalization's influence on New Zealand's economic policy: "Globalization did not begin to shape policy options in New Zealand because it was a more or less faithful representation of some underlying reality. Rather it was a policy strategy that was useful to the Labour government in addressing the tensions associated with a particular programme" (1998, p. 604). Similarly, CRAs' influence in New Zealand politics was not the result of certain deterministic economic structures. Rather it provided the National government an opportunistic means to address some of the tensions embedded in its program of economic restructuring. Namely, the increasingly dire state of private debt and private savings in New Zealand and their association with government policies was able to be offset by the agencies' judgments, which were used to reinforce the government's economic program of deficit reduction.

Despite the now common-sense idea that CRAs' negative judgements erode national sovereignty, through a discussion of the New Zealand interactions with the CRAs, I have argued that governments can potentially use such judgements to their advantage. Governments are able to actively contribute to, and at times undermine, the discursive environment that underpins CRAs' power, although they cannot control it. Governments are able to govern at a distance and enhance their internal sovereignty by drawing from the expertise of the rating agencies to legitimate pre-existing economic policies. Their external sovereignty is also strengthened as they "filter" the recommendations of a traditionally private, non-state actor. By co-opting the expertise of the rating agencies, governments in turn help construct and solidify that very expertise. The authority of credit ratings is thus neither an exclusively private construction, nor simply the result of government action, but represents a complex amalgam of the two. We must recognize this hybridity and complexity if we wish to better regulate financial markets and their systemic instability that has come to characterize neoliberal globalization.

Through both deliberate and non-deliberate processes, the CRAs and the National government further entrenched neoliberalism in New Zealand. Drawing from the definition of neoliberalism in Chapter 2, the state-CRA interactions through 2008 and 2012 saw the state adopt a positive role by facilitating and reinforcing the social and discursive environment underpinning capital mobility and the agencies' expertise.

The state's role was also redefined as a "hands-off" facilitation of private enterprise and away from a provider of social goods and services. This ongoing transition saw the development of a regime of techno-managerial governance in which unwanted political interference in economic decision-making was limited by the government who, in co-opting the CRAs' expertise, sought to erect a barrier between the technical economic policies prescribed by the agencies and subjective political processes. By generating the perception that such economic policies were governed by technical criteria, as well as the belief that any divergence from the pre-existing policy program of deficit-reduction would incite a disastrous rating downgrade, National largely succeeded in generating self-regulating subjects.

The last two chapters sought to examine the multifaceted and situated process by which CRAs came to be involved in New Zealand politics. By exploring this process, the elements of innovation, experimentation, and contestation, were brought to light. The National government did not plan to use the CRAs to reinforce their project of economic restructuring, rather in a serendipitous encounter between the two entities the National government experimented with co-opting the agencies' expertise. Economic restructuring in New Zealand was and still is an experiment. In highlighting the diversity, heterogeneity and ad hoc nature of globalization in general, and CRAs' influence in particular, the thesis opens up political space to consider multiple possible forms of resistance to the structural totality that has come to define the global economic system. Any rejection of the contingency and undecidability of globalization and accompanying processes produces an object that is a slave to history, rather than a subject who attempts to transform it.

Limitations and Future Research

This research has some inherent limitations. Most significantly, due to costs involved, I was unable to access full CRA reports accompanying changes to New Zealand's sovereign rating. Accessing these reports would be vital to any future research that seeks to compare the agencies' recommendations with their representation by politicians. It should also be noted that there is an inherent ambiguity within the transformationalists' argument: both a co-construction and a globalizing elite argument were simultaneously presented. These two causal variables work together in complex and interconnected ways,

and one is not sufficient without the other. Elements of transnational, class-based agency are apparent in the New Zealand case, but to limit the analysis to such a variable would miss the way in which discourse constructs individual subjectivity in diverse and variegated ways. Space constraints prevented a further elaboration of the globalizing elite argument, which is relatively well covered in the literature (see Gill, 2008; Panitch & Gindin, 2012). Future research should further develop the relationship between these two elements of globalization.

This case study was not typical of studies looking at CRAs influence because the government's credit rating remained within margins of excellence and the government followed policies that can be generally considered neoliberal. Thus, while this ability of governments to co-opt the expertise of the rating agencies is available to countries like New Zealand that maintain a high credit rating, the same opportunities may not be available to lower rated countries as the economic impacts of a rating change may be far more substantial. Additionally, the question of whether governments that pursued more socially-inclined policies – such as a high tax bracket for high-income earners or the nationalization of assets – would have the same flexibility as the National government, requires additional case studies. To further test the notion that CRAs are able to punish countries that deviate from neoliberalism, a case should be selected that substantially deviates from neoliberal policy prescriptions. National policies, whilst negating elements of the agencies' advice, were still broadly consistent with neoliberal policies. Thus, the question of whether states can pursue non-neoliberal policies in the face of the agencies' negative judgements requires further study.

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